Infratil Energy Australia

29 December 2009

Mr Troy Forward
Manager, Market Development & System Capacity
Independent Market Operator
PO Box 7096
Cloisters Square
PERTH WA 6850

2012-13 MAXIMUM RESERVE CAPACITY PRICE SUBMISSION

Dear Sir,

Thank you for the opportunity to comment on the Independent Market Operator's (IMO) draft report, "Maximum Reserve Capacity Price Review for the 2012-13 Reserve Capacity Year" issued in December 2009.

You will recall that we wrote to the IMO on the 8 April 2009 to share some of our concerns regarding:

- the **Reserve Capacity Mechanism** (and its use in the Wholesale Electricity Market to ensure the timely and efficient supply of generation capacity); and
- the formulation of the weighted average cost of capital (**WACC**) and the choice of parameters used in its calculation.

We understand in 2010 a review of the Reserve Capacity Mechanism will be undertaken including the process by which the Maximum Reserve Capacity Price (MRCP) is calculated. We appreciate that many of the concerns raised in our earlier letter will be addressed at that time.

That said we would still like to take the opportunity to comment on several aspects of the draft 2012-13 MRCP determination.

GENERAL

Firstly, we believe that it is important to remember that:

- ◊ the Reserve Capacity (or administered) Price in any given market year is **the only visible price for capacity available to investors and financiers**;
- ◊ that this price will be equal to **85% of the MRCP scaled back for over-supply** in the absence of a Reserve Capacity Auction[1]; and
- ◊ that **absolute quantum** and **minimal year to year variations in this price** are **very important** to private sector investors such as Infratil and their debt financiers.

That said, Infratil is supportive of the methodology and the choice of parameters used to compute the various components of the 2012-13 MRCP with the exception of the WACC.

Before we consider the WACC in detail we offer the following comments on the some of the other key aspects of the report:

- ◊ The power station capital and development costs both seem reasonable given Infratil's recent experiences at Kwinana;
- ◊ While the operations and maintenance costs appear reasonable, Infratil notes that the cost of operational insurance seems to have been ignored;
- ◊ Infratil supports the principles behind the calculation of the dedicated and shared transmission connection asset costs and appreciates the wide range of potential costs that may arise. We did however find it difficult to understand how the IMO arrived at the "TC[2010]" cost in the report based on the information provided by Western Power and suggest that some additional transparency on how these costs were computed would be helpful in future;
- ◊ Infratil congratulates the IMO on their approach to dealing with land costs and their linking to the cost of shared transmission connections.

[1] Infratil believes that investors will consider it too great a risk to participate in an auction that may never take place having spent significant funds to advance a project to a state where its ready to be delivered in a little over two years.

WEIGHTED AVERAGE COST OF CAPITAL

As we stressed in our previous letter, **generation capacity revenue does not have the same risk profile as regulated revenue earned by a wires business.**

In determining an appropriate WACC, The Allen Consulting Group (**ACG**) have had *"…to fall back on regulatory precedents on energy network businesses for comparison"*[2] as there are no precedents on price regulation for generation infrastructure in states other than Western Australia.

Infratil believes that to liken an open cycle gas turbine (**OCGT**) peaking plant "business" to a regulated electricity transmission or distribution businesses is flawed especially when there is very little prospect of a Reserve Capacity Auction taking place and hence the IMO entering into any Long Term Special Price Arrangement.

Energy network businesses do not bear the risk of:

- **material penalties** in the form of capacity credit refunds if the high level of plant reliability demanded by the IMO is not maintained[3]; and
- the prospect of **material price variations** year to year;

but an OCGT peaking plant does in the WEM.

WACC Parameters

Infratil offers the following comments on the WACC parameters used for the 2012-13 MRCP determination:

- **Forecast rate of inflation:** In section 4.3 of their report, ACG discusses the need to carefully choose the forecast rate of inflation. It calculated the implied (forward looking) inflation rate derived from the Fisher equation using Government coupon bonds and inflation indexed bonds at 2.4%.

  ACG went on to say that,*"…the forecast (2.4%) in well within the RBA's inflation target band of 2 and 3 percent per annum"*, however it then chose a materially higher value of 3.0% for this "10 year" forecast biased by the events of the last 12 months.

  Infratil does not consider this inflation forecast is consistent with the market's future expectations and notes that the Economic Regulation Authority of Western Australia (**ERA**) used what appears to be a forward looking inflation forecast of 2.47% in their final decision on Western Power's revised access arrangements[4].

[2] "WACC Parameters Update for the Purpose of Determining the Maximum Reserve Capacity Price", The Allen Consulting Group, October 2009

[3] It should be noted that there is no force majeure relief from these penalties and that the risks of non-performance of a generation asset is far higher than those of stationary network assets.

[4] Economic Regulation Authority of Western Australia, "Final Decision on Proposed Revisions to the Access Arrangement for the South West Interconnected Network", 4 December 2009

Given that the forecast rate of inflation is solely used in the Fisher equation to strip out inflation expectations from the nominal WACC, it would be inappropriate to use anything other than 2.4%.[5] To do so would be inconsistent with the quoted real risk free rate of return of 3.15% in the ACG report (Table ES.1 and section 4.2)

◊ **Debt Margin:** ACG has used a number of analytical methods to compute debt margins for BBB+ entities resulting in values that range from 214bps to 413bps. Infratil's experience is that whilst there is downward pressure on margins compared with those being offered by the banks 12 months ago, BBB money is still only available at between 325 and 375bps.

◊ **Equity Beta:** As an investor in regulated and non-regulated energy infrastructure assets for almost 15 years, Infratil believes that for a peaking plant business of this nature in this market, an appropriate asset beta would be 0.65 and hence at 40% gearing the equity beta would be 1.08.

⇒ Infratil appreciates the difficulty for the IMO and its consultants to choose the right asset beta given the uniqueness of WEM and its rules. Infratil contends however that a "weighted" average asset beta of listed international generation and wires businesses is an inappropriate means by which to compute this parameter.

For example, in 2008 ACG proposed an asset beta of 0.50 based on a group of mainly US and Canadian companies and then in 2009 it proposed a value of 0.42 based on a materially different group of companies. What's important to note here is that over the past 12 months the risk profile of building and operating a OCGT peaking plant business in the WEM has remained by and large unchanged, (if anything it may have increased a little), and yet ACG seems comfortable to propose a 16% decrease in the systematic risk of the asset.

Infratil believes that in the absence of any material changes to the Market Rules and hence the risk profile of an OCGT peaking plant business, the asset beta should remain unchanged from year to year. To that end Infratil applauds the recent decision by the IMO not to adopt AGC's 2009 proposed asset beta of 0.42.

⇒ Currently the WACC does not take into account the construction risk carried by the proponent for a greenfield development and which is not present in an operating project (or company)[6]. The most appropriate way of capturing this risk, particularly given the way the WACC is applied, is to have a slight uplift in asset beta, (which has been included in the suggested value of 0.65 above)

◊ **Value of Imputation Credits:** Infratil is very supportive of the IMO's decision to maintain Gamma at 0.50 for a business of this nature.

[5] Note that using a an inflation rate of 3.0% together with a nominal risk free rate of 5.62% implies a real risk free rate of return for the project of 2.54%.

[6] It's important to note that the construction risk premium is material and is priced into finance facilities by banks and equity participants.

CONCLUSIONS

Infratil believes that whilst the absolute quantum of the 2012-13 MRCP fairly reflects the fixed costs and risks of operating an OCGT peaking plant business in the WEM there are a few aspects of the MRCP "recipe" that still require some refinement.
In particular the choice and "stability" of the WACC parameters should be a future focus for the IMO to ensure continued investment in the WEM and to limit, to the extent possible, year to year MRCP variations.

I trust you'll find the above comments constructive. Please feel free to contact either myself or Roger Crawford in the event you wish to discuss the issues raised in this letter further, our contact details are as follows:

Darryl Flukes
Phone: (03) 8680 6402
Email:
darryl.flukes@infratilenergy.com.au

Roger Crawford
Phone: (07) 3220 0949
Email:
roger_crawford@hrlmorrison.com.au

Yours faithfully

for and on behalf of
Infratil Energy Australia Pty Ltd

Darryl S Flukes
Chief Executive Officer