Greg Ruthven
Acting Manager, System Capacity
Independent Market Operator

By email: imo@imowa.com.au

17 January 2012

Dear Greg,

Maximum Reserve Capacity Price for the 2014/15 Capacity Year

Thank you for the opportunity to comment on the IMO's Draft Report, December 2011. Thank you also for the promptly arranged workshop to discuss the WACC– a very useful initiative.

Before commenting on the report specifically, we feel compelled to stress again the detrimental impact that such volatility in the annual MRCP is having on investment decisions. It is ironic that a process designed to assist investment certainty is having quite the contrary effect through highlighting the very real regulatory risk present in the SWIS.

While we understand the original function of the MRCP (and RCP), it clearly now, as the only observable price for capacity, plays a critical role for investors in developing strategy around such things as market entry, growth and competitiveness, and for debt providers in determining debt levels, costs and, critically, tenor.

Though we understand that this is outside the scope of the report, this is too critical a point to withhold comment. We also understand that there is to be a review of the Reserve Capacity Process this year and look forward to actively participating.

Turning to the report itself, at the high level the MRCP outcome seems intuitively wrong. The returns on investments of such a long term nature should not vary greatly year on year so to fall by 9% does not appear rational. Further, with all the stresses of the last few years, to have an MRCP lower than that determined 4 years ago (with similar transmissions costs) is highly questionable.

Clearly the primary culprit is the WACC, the subject of the IMO convened workshop, on which we provide the following comments.

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Infratil Energy Australia

WACC

The WACC outcome, over 150bp lower than 12 month ago, again appears counter-intuitive in the current economic climate.

The key parameter driving this outcome is fall in the Risk-Free Rate. However, it is Infratil's view that such a sharp fall in interest rates would not be accompanied by no movement in other parameters in the WACC formula, in particular the equity Market Risk Premium.

Under 2.9.4(b) of the Market Procedure, the IMO has discretion to "review and determine the 5 Yearly components...if, in the IMO's opinion, a significant economic event has occurred since undertaking the last 5 yearly review...". Clearly this is subjective but Infratil would strongly contend that a sharp fall in Government bond yields of some 200 bps (30%) since mid 2010 (noting it is unclear what data points were used by the MRCPWG in assessing the parameters) and a level now lower than that reached during the heights of the 2007/08 GFC does constitute such an event. In order to correct what almost all observers and commentators view as a "wrong" WACC outcome, this appears the only course of action available to the IMO and it would be travesty for the IMO not to pursue this.

Infratil does not intend to make specific comment on the 5-Yearly components in this paper, pending the IMO's advice regarding the above procedure, but looks forward to commenting at the appropriate time. In the meantime however, we would point to the substantial evidence and recent publications demonstrating an elevated MRP and would be happy to provide references should you require.

On a further note, it may be necessary to review the procedures relating to the 5-yearly components in order to have them reviewed on a more regular basis without having to demonstrate an "event".

Turning to the Annual Components:

Inflation

We note that the RBA forecast is used rather than an observable and/or implied market rate[1]. Historically, we understand that lack of liquidity / data on inflation-linked bonds drove the IMO and other regulators to resort to the RBA forecast as the source; however, we understand that liquidity and reliable data has now returned so encourage the IMO to revert to these market sources.

[1] We note the Draft Report p22 states that "The risk free rate is determined from observed Commonwealth Government bonds"; this is the case for the Nominal RFR but, by using RBA forecasts for inflation, not so for the Real RFR.

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Debt Risk Premium (DRP)

As noted by Merredin Energy in its memo of 30 December 2011, it does seem perplexing that the DRP should have reduced by 100bps over the previous 12 months. Given the lengthy comments the report, and those of PWC at the workshop, regarding observable and reliable yield curves we would encourage the IMO to consider incorporating Credit Default Swaps in the methodology for determining the DRP as suggested by Merredin Energy.

Power Station Capital Costs

Infratil draws the IMO's attention to the caveat in the SKM report in relation to water availability, where it states "...assumptions are based on sufficient potable or similar quality water supplies being available local to the facility either through pipe or tanker delivery. The requirements for extensive or complex water abstraction or treatment facilities have not been considered."

It is our experience that the cost of delivery of suitable quality water to the site is material and should be included in the Power Station Capital Costs.

Further, the availability of sufficient, suitable water is a key consideration in any power station site location but does not appear to be incorporated into the **Land Costs** assessment. This may be achieved through ensuring the differential costs of water supply are consistent with the land costs, i.e. lower priced land in regional/rural areas will almost certainly have higher costs for water supply and vice versa.

Impact of Methodology Changes to Input Parameters

Although outside the scope of this report, we feel compelled to comment again on the allowance for funds used during construction (compensation period). We refer you to, and strongly reiterate, the points raised in our submission dated 13 September 2011 (relevant extract attached); the 6 months used is just not credible. We encourage the IMO to investigate recent generation investments in the SWIS (and elsewhere) to observe their experiences.

Again, thank you for the opportunity to comment. Please feel free to contact me on 0419 138 828 or darryl.flukes@infratilenergy.com.au should you wish to discuss any of these issue further.

Your sincerely,

Darryl S Flukes
Chief Executive

ATTACHMENT

Extract from letter to 13 September 2011 "Five Yearly Review of the Methodology and Process for Determining the Maximum Reserve Capacity Price Submission."

"Infratil believes that the allowance for funds used during construction (AFUDC) is insufficient based on its recent experience in building a peaking OCGT in the SWIS and refutes PwC's recommendation.

It is our experience that construction cash outflows do not occur in the manner described in PwC's document with material outflows required prior to the commencement of site works, specifically those associated with:

- the initial (and in some case multiple) payments for major items of plant;
- detailed engineering designs;
- debt raising due diligence;
- equity raising;
- project contract negotiations; and
- the securing of leases, licenses, access rights and easements.

Further, while site works may take as little as 12 to 14 months to complete, these works would be scheduled to be completed at least 3 months prior to the beginning of the Market Year on 1 October to allow for any construction over-run and the avoidance of loss of income and/or penalties.

Based on very recent experience, Infratil is of the view that a realistic construction period for the determination of AFUDC is 24 months with an "effective compensation period" of 12 months."