

15 December 2010

Troy Forward
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Confidential

Dear Troy

Draft Report: Maximum Reserve Capacity Price Review for the 2013/14 Reserve Capacity Year

Perth Energy welcomes the opportunity to provide comment in response to the Independent Market Operator's (IMO's) draft report setting the Maximum Reserve Capacity Price (MRCP) for the 2013/14 Reserve Capacity Year.

Perth Energy's overall view is that we support the MRCP determination of \$232,500/MW for the 2013/14 year. Perth Energy also observes that as a result of the comprehensive reviews adopted in prior years, and the more recent operation of the MRCP Working Group, the process and methodology for calculating the MRCP now appear to have stabilised. This is a significant improvement on the experiences of prior years, in which the year on year variations were material. Perth Energy welcomes this development and highlights that a predictable and stable review process, leading to a predictable price outcome, is absolutely fundamental to maintaining investor confidence and enabling new power station projects to obtain finance.

Within this letter we highlight some of our remaining concerns with the methodology underpinning the derivation of the MRCP for the 2013/14 year.

Transmission Connection Costs

Perth Energy notes this is now the second annual review of the MRCP where the IMO has sought to provide for a more appropriate level of transmission connection costs. We welcome this approach but observe that this highly significant component in the cost stack remains volatile. The variance from the previous year estimate for Shared Connection Costs is 22%. It is Perth Energy's understanding that this variance is mainly driven by changes in network configuration from the previous year (e.g. it has become more or less constrained), leading to different network augmentations being necessary, when compared to those that were required one year ago.

Perth Energy continues to support a change to the methodology adopted for Western Power's Access Arrangement to calculate Deep Connection Costs. In particular, Perth Energy would welcome a move towards a "shallow" connection costing methodology where appropriate, whereby a high proportion of the expenditure currently classified as being for "user specific" assets becomes part of the wider network and is included in Western Power's

Regulatory Asset Base. “Appropriateness” depends on 1) the particular location on the Network that a user wishes to connect, with strong nodes within the SWIS being allocated a more shallow cost than a weak node location, and 2) whether a connection is unambiguously designed for the purpose of supplying the SWIS as a whole compared to a large discrete load.

Such a change would see the connection costs charged to users more fairly, with those servicing the market as a whole being charged via normal Use of System (UOS) charges while those servicing special purpose loads being charged a more user-pay, deeper connection cost. This would remove much of the volatility from the resultant MRCP calculation. We note that to implement such a change it would be necessary to change Western Power’s current Capital Contributions Policy.

Regarding the use of the least cost connection option as the basis for the Transmission Cost Component in the MRCP, we are not sure of the reason. As evidenced by Western Power’s report to the IMO, the cost estimates varied from \$45 million to \$586 million (more than a 13 fold increase from the lowest to the highest cost alternative) across the seven locations that were considered. Applying the lowest of these estimates would imply under-recovery of transmission costs.

Gas lateral costs

Perth Energy continues to advocate the benefits to system security of incentivising fuel diversity in the South West Interconnected System (SWIS). To facilitate this, the MRCP should allow for the costs of constructing gas laterals in the cost stack. We note (again) that this cost element was specifically allowed for within the MRCP at Market Commencement.

Insurance costs

We note that there remains no allowance for insurance costs in the MRCP. Insurance costs for a 160MW OCGT would be in the order of \$1m per annum, or just over \$6,000 per MW. Insurance is a necessary component for any prudent power station operator and Perth Energy suggests that such costs be explicitly provided for in any future MRCP reviews.

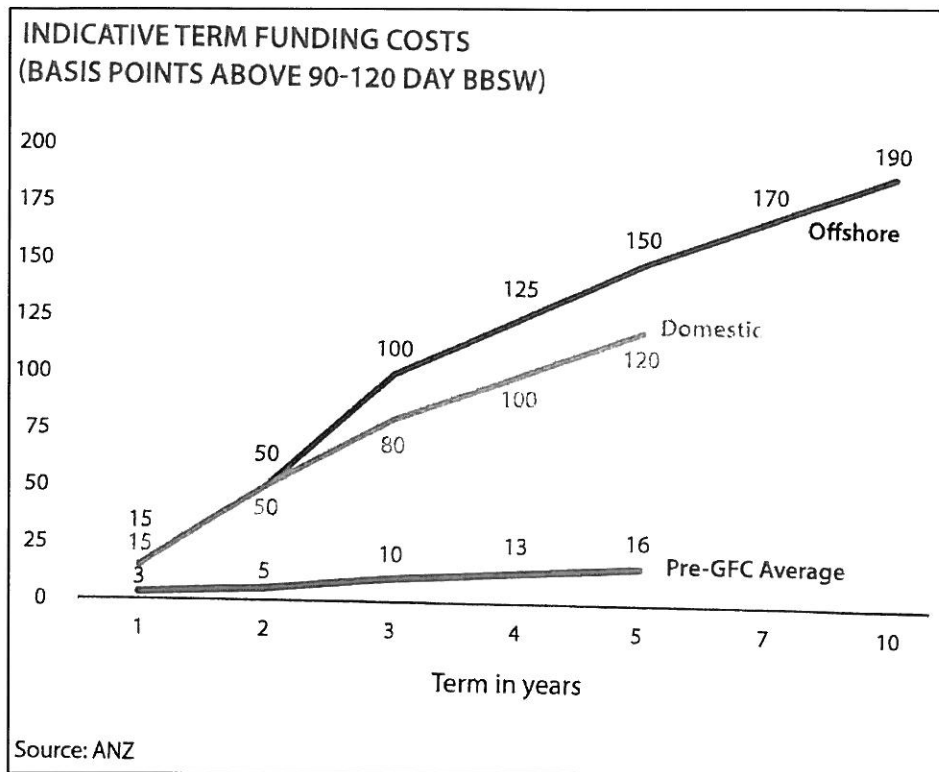
Escalation parameters

Perth Energy notes that some of the indices to be applied to escalate certain cost parameters have been based on the actual movement in base metals prices between 2009 and 2010. This resulted in a decrease in these cost parameters. The MRCP is forward looking and is meant to reflect the cost of providing generation capacity in future years. Perth Energy would therefore suggest that historical movements in base metal prices are not relevant for cost escalation purposes and suggests the IMO investigate the potential use of forward estimates for base metals prices for the next MRCP review.

WACC

As discussed in our submission last year Perth Energy remains concerned at the potential underestimation of the cost of funds required to build power stations. Wholesale funding costs, which drive lending margins, have continued to increase since the GFC, on top of the rises in the domestic cash rate, as shown in this ANZ chart. However, we would like to note

this as a word of caution rather than disagreeing with the WACC as proposed in the IMO Report.



Perth Energy appreciates the extensive consultation that the IMO has engaged in to determine an appropriate MRCP for 2013/14. We would welcome an opportunity to meet with the IMO to discuss these issues in further detail.

Yours sincerely

**KY CAO
MANAGING DIRECTOR**