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Dear Greg

MRCP - Response to Comments Raised Through Stakeholder Feedback

1. Introduction

This letter is in response to your emails dated 19 January 2012, 27 January 2012 and 30 January 2012, requesting SKM feedback on comments raised in the stakeholder feedback process of the annual Maximum Reserve Capacity Price determination. The commentary below seeks to address the topics raised in your emails for which you have requested a response.

2. Insurance

> *Merredin interpreted from SKM's report to the IMO that the reduction of the insurance component of margin M meant that the cost of construction insurance was no longer included in the MRCP. Can you please indicate which of the line items in Table 2-1 of the SKM report (make-up of the Power Station Cost) includes the insurance during the construction phase, and advise what the approximate value is that is included?*

The construction works insurance cost is included in the EPC price. On a greenfields, turnkey project this would be considered the usual case. In the PEACE program, construction insurances are included in the "Contractor's soft and miscellaneous costs" which in the report are in the "Contractor's costs" line item. Within this line item of $18,560,000 in Table 2-1 of the SKM 2012 MRCP report is an allowance of $2,160,000 for bonds and insurance which would incorporate allowance for construction insurance.

It would be a double-count to include them again in the "M" factor. The other insurances paid for by the Owner would be PI and PL. Workers' Comp insurance for the owner's and consultants' staff would be within the relevant owner's costs items.

3. Carbon legislation

> *Merredin has pointed out that the carbon tax legislation has passed parliament since the report was provided to the IMO. Is the potential impact of this on the power station cost, O&M costs and margin M components known/able to be estimated?*

The effect of escalation is included in the WACC and CPI forecasts used in the escalation factors. Any impact of carbon pricing on elements of the O&M costs and capital costs for goods and services in Australia should be incorporated within the projected escalators and not (again) within the capex or M factors.

The escalators already recognise the likely inclusion of a carbon price on costs generally. For example the Reserve Bank's Statements on Monetary Policy in August 2011 and November 2011 referred to the impact of a price on carbon.

4. Debt raising costs

Debt raising costs were removed from the previous years' finance raising cost allowance.

We reduced the allowance by 1% being the approximate NPV equivalent of 12.5bp for 15 years at the pre-tax real WACC, as we believe is appropriate in this application.

5. Increased Project Management and Owners Engineers costs due to inlet cooling?

The Project Management Cost included in the Margin M are the "Owners" project management costs, as distinct from the construction based project management costs included in the core cost estimate. SKM are of the position that, given the water infrastructure required to drive the inlet cooling was included in previous years (for the purposes on NOx abatement), the impact of including inlet cooling on the Owners Project Management costs would be minor, if any at all. Any impact would be well within the level of accuracy of the estimate.

6. Increased legal costs due to registration/compliance for carbon tax?

SKM have not specifically included any allowance for increased legal costs resulting from any requirement to register / comply with the requirement of any Carbon Tax. SKM note that reporting of Carbon emissions is current required under the National Greenhouse and Energy Reporting Act 2007 (NGER Act). At this time SKM has not established a view on the cost impact of any obligations beyond the existing reporting requirement or if the impact of any obligations should be included in the Margin M.

7. Basis of Cost Estimates

EnerNOC has drawn attention to the statement in your report stating that OEMs did not respond to requests for quotes. EnerNOC also drew attention to the change in the relative weightings of project data and market data, and asked whether the details of the weightings could be published.

In establishing the Review of the "Maximum Reserve Capacity Price Power Station Elements" report SKM have always used a combination of actual project data and GT Pro / PEACE. In previous years' reports SKM used actual WA project data and escalated this data. This data was then confirmed against the data within GTPro and PEACE. To the extent there were material discrepancies, the project data was adjusted based on the source of these discrepancies. Through this process no specific weighting was applied, however the project data was most heavily relied upon.

In the 2012 report SKM identified that the WA project data had aged beyond that which was considered acceptable to use as the basis for the MRCP Power Station Elements estimate. This particularly applied to the cost of equipment and the unit rates for labour and materials. The relevant hours / units are still considered appropriate references. To address this, SKM changed the estimating process to be based on GT Pro and PEACE with a cross check against components of the relevant project data (hours units etc). This changed the "weighting" to data within GT Pro and PEACE. SKM also sought input from major OEM's providing 160 MW solutions into Australia as a further cross check, as indicated in the report no data was provided by these OEMs. Further context on the PEACE software are provided below.

PEACE

Thermoflow GT Pro PEACE software provides preliminary engineering and cost estimation for the GT plant as designed in GT Pro. The logical cost functions for all equipment and balance-of-plant are derived from the detailed hardware specifications, so that any design change is immediately reflected in corresponding changes in both performance and cost.

PEACE first calculates a Reference Cost that pertains to the hypothetical "Reference US Site" which is the basis for all internal calculation procedures. An Estimated Cost is then calculated at the actual site by applying a Regional Cost Multiplier which allows the user to adjust the estimated cost as a function of plant location and Cost Modifiers, which are correction factors to be applied to the various quantities (labour rates, equipment costs, commodity costs) estimated by PEACE.

The gas turbine generator set costs used by PEACE are based on data sourced from GT OEMs at regular intervals.

The Estimated Cost is the total cost for the GT plant estimated at the actual site, including freight charges, sales taxes, import duties, foundations, rigging, erection & installation, etc.

All PEACE costs (labour, equipment, commodity, regional cost multipliers) are revised each year (usually March) to account for escalation.

8. A general comment

We do not anticipate that it is intended that the calculation of capex or the "M" factor be of unreasonably detailed accuracy, but that it should be unbiased. The cost of investigations to produce a more accurate estimate should be weighed against materiality and the accuracy inherent in other parts of the procedures. The use of the "contingency allowance" for minor items not explicitly costed but nevertheless expected to be incurred is considered the appropriate treatment for allowing for these minor items without omitting them.

Uncertainty necessarily remains within any estimate.

For example, we have noted above the expected range of uncertainty in the estimates themselves in the section that discusses contingencies.

We also note other approximations in the broader method that would be of much larger impact than some of the small issues noted, for example:

- The use of the statutory tax rate in the WACC instead of the effective tax rate will over-estimate the actual annualised cost;
- the incorporation of the land cost within the calculation of the annualised cost in the manner applied by the method treats the land as being "consumed" over the life of the project. This is a coarse treatment and over-estimates the cost. Land should be handled by an appropriate return "on capital" and not by a return "of and on capital" as provided; and
- similarly, regarding the actual plant cost, the adoption of a 15 year amortisation period with nil residual could seem conservatively biased to an over-estimate of costs. We understand that this factor is one of the reasons for the 15% adjustment in the MRCP when it is applied as a "price".

Yours sincerely

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