1st December 2010

Mr Glenn Appleyard
Chairman
Office of Tasmanian Economic Regulator
GPO Box 770
Hobart TAS 7001

Dear Mr Appleyard

FCAS Pricing Investigation – Draft Report

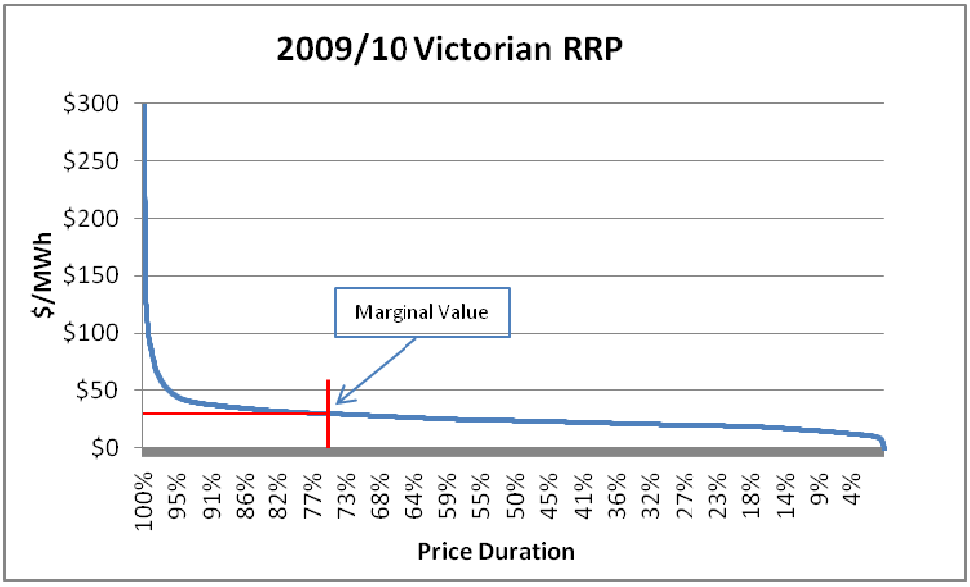
Thank you for the opportunity to make a submission into the above mentioned draft report.

As stated in previous submissions, Infratil Energy Australia (IEA) strongly supports the regulators decision to declare FCAS as a declared electrical service given the monopoly that Hydro Tasmania has in providing raise services for local contingencies.

Whilst IEA agrees with the need for price controls in this market, and is in general agreement with the pricing methodology, it disagrees with some components of the pricing inputs being put forward.

The use of a Victorian Peak price to value lost generation

The foregone energy should be valued at the margin i.e. the opportunity lost or the marginal value of generation. It is reasonable to assert that Hydro Tasmania will be generating at maximum output during periods of high Victorian prices (subject to Basslink export constraints) regardless of foregone energy. On the basis of Gordon power station operating at a long term average capacity factor of ~25%, this foregone energy should be valued at the 75th percentile of a price duration curve. Using financial year 2009/10 as an example this would equate to ~$30 as illustrated in the below chart.



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The ongoing calculation of a marginal generation value is likely to be difficult to determine and agree upon as well as failing to meet the regulators desire to have clear and transparent inputs. A simple principle to apply however would be to assume that Hydro Tasmania would always capture its "capacity" value – commonly accepted to be the value of a cap struck at $300/MWh. IEA therefore recommends that, should the peak swap price be used as an input to approximate the marginal value of lost generation, then it should at least have the capacity value deducted to obtain a value of energy without the capacity premium.

As a peak cap price is not widely published IEA suggests an approximation be used of the published flat cap price multiplied by 2. By way of example, based on today's SFE calendar 2011 Victorian pricing, the value of lost energy would be: ($49 – ($7.35 * 2)) = $34.30. This is much closer to the historical marginal value determined through the more complex price-duration method above

The application of fixed costs outside periods of local requirement

The report proposes the variable costs be applied only when the local requirement is called but does not apply the same criteria for applying fixed costs, the report indicates 70% based on the period of time Basslink is importing. IEA is of the belief that the two components should match in their methodology and therefore both be based on when an actual local service is required. By using the duration of all periods Basslink is importing unduly overstates the fixed costs that should be applied.

Along with IEA's main points of consideration around the pricing inputs explained above, it notes other secondary areas of concern arising from the proposed methodology.

A lack of regulation on other terms and conditions of a contract
There does not appear to have been consideration given to regulating all aspects of the safety net contract, in particular credit requirements. Whilst IEA acknowledges the importance of robust credit requirements, the proposed method leaves open Hydro Tasmania's ability to apply onerous credit obligations to these contracts.

The duration of price resets
The ability to provide long term price stability is essential for existing and new entrant generation within the region. Provided the pricing inputs used are able to be managed longer term, as is the case in using an exchange traded contract price and over the counter REC price, then IEA would be accepting of a six month price reset. If however the price inputs to be used cannot be managed through various market traded products then IEA would be advising a longer duration between price resets.

It is critical that through this process the regulator establishes a mechanism that will promote an efficient and effective market environment. A failure to satisfactorily protect generators from the costs arising as a result of an abuse of market power will continue to stifle investment from new and existing participants within the region.

I look forward to hearing the outcomes of this draft consultation, should you wish to discuss any matter further please contact me directly on 03 8680 6405 or email will.mcindoe@infratilenergy.com.au.

Regards

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