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TESLA Corporation

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Dear Allan,

Thank you for the opportunity to comment on the draft report for the Maximum Reserve Capacity Price (MRCP) for the 2014/15 Capacity Year dated December 2011.

Tesla is disappointed with the proposed pricing outcome as we believe it has significant ramifications for the long term development of the generation market in Western Australia. One of the strategic goals of the State's energy strategy is "To ensure a transparent, stable market based regulatory environment to deliver competitive energy prices for consumers and an attractive environment for energy investors". This scale of the proposed reduction puts this goal at risk.

Tesla is submitting a paper commenting on the MRCP for three reasons;

- We have concerns regarding the viability of small players (including ourselves) in the Wholesale Electricity Market (WEM). The original intent of the WEM was to encourage a variety of participants – which encouraged Tesla to enter the market. The outcome of the MRCP Review now clearly biases the WEM in favour of the large "established" players.
- The current electricity market when viewed in its entirety (i.e. from fuel to generation to wholesale to retail to consumers) is currently prevented from working efficiently and fairly by the overwhelming dominance of Synergy in the commercial and domestic retail sector. In effect, Synergy, as the only player capable of writing bankable offtake agreements, can choose who wins and loses.
- To provide potential solutions to assist the overall orderly development of the WEM so that "price shocks" are minimized over the journey to efficient market operation.

Whilst we are seeking a review of certain aspects of the draft MRCP, we believe the following points should be taken into account when going through the Reserve Capacity Mechanism Review performed by the soon to be formed Reserve Capacity Mechanism Working Group (RCMWG). Following the RCMWG review, we believe the pricing methodology should be again reviewed as the whole mechanism should have been reviewed prior to the price procedure independently being modified. We would also like to ensure that the responses by all participants, including smaller capacity providers like Tesla need to be included in the overall industry response.

Viability of Small Generators

It was recognized in the original reform process and market rules that WA electricity needs would be best served by having a range of fuel types and sized players in the WEM. The recommendations from the MRCP Review appear to serve to work directly against this intent.

Some of the decision making (e.g. the inclusion of air inlet cooling) is artificial because the efficiency effect of this is not uniform across the SWIS (and neither are the humidity levels which is a key input to the cost/performance of air inlet cooling). It is a retrospective adjustment to a market establishment fundamental, is discriminatory to those players who made investment decisions on the original plant specifications and was only supported in the review process by the retail sector - further evidence of retail market power being increased rather than decreased.

Market Operation and Efficiency

The outcome of the MRCP Price Review suggests to Tesla that the IMO has formed a view that the WEM is not yet operating efficiently. Tesla also has that view however, we believe that instead of manipulating inputs to the supply side to counter a potential generation oversupply the market should be allowed to achieve equilibrium in the following manner:

- Provide incentives for more players to enter the retail sector as this is the key to WEM efficiency. If necessary undertake further reform to reduce Synergy's market share and/or its ability to use its market power to exclude participation by other market participants;
- Allow the generation sector to find its own benchmarks where the MRCP provides sufficient/insufficient incentive to generators of all types/fuel etc. This is key when Synergy is able to discriminate in its decisions about which generators to offer bilateral agreements and their duration, terms and conditions. A "surplus" of generation is essential to attract new retail entrants. Without surplus the status quo of Synergy exercising market power will remain.

Suggestions for Market Development

Tesla's suggestions for continued orderly development of the WEM using the MRCP review mechanism are drawn from our comments made above:

- Allow the generation sector to take the final steps to market equilibrium without the artificial manipulation imposed by the MRCP Review. The IMO should not react to short term views that the generation market is over supplied and think that is the problem when in fact it is needed to be part of the entire long run market solution;
- Consider what further reform of the retail sector needs to be undertaken to reduce Synergy's market power so that all generators that have been encouraged into the WEM can obtain some risk management via a bilateral agreement;
- When undertaking market reviews of any type give consideration to the needs of the smaller non-established players that the WEM was designed to encourage into the market. Having done that, the MRCP Review and the resultant pricing now threatens their viability.

Impact on Tesla

Tesla operates peaking power plants and relies on the capacity price mechanism to fund its business and provide a return to shareholders. We commenced operations in August 2011 and are currently constructing 3 additional plants which are due for completion around the middle of this year. Our business model has been developed based on a range of market and industry factors including an assessment of future MRCP prices. Tesla understands that it operates in a regulated environment that manages price setting, however this process should ensure that pricing changes are transparent and provide stable and predictable price fluctuations (both positive and negative). Business investment decisions need to be made based on a reasonable level of pricing certainty to enable capacity providers to make informed decisions given the long term nature of the generation assets. Significant pricing fluctuation create increased regulatory uncertainty and will negatively impact on our (and other capacity providers) ability to access both debt and equity markets.

If this pricing decision is approved Tesla will be forced to review its business model and strategy and based on this pricing level will not be applying for additional capacity credits in 2012 for the 2014/15 capacity credit year.

In our submission to the proposed MRCP procedure change we commented that over the long term the change will increase the cost of electricity supplied to customers through reducing the attractiveness of the market to new generators and therefore the level of new generation capacity on the network. It will also reduce the security of the network as a whole, as generation will become more centralised, relying on transmission for energy transfer instead of distributed embedded generation which is a trend we see in other networks. In the short term electricity costs will be reduced (provided Synergy passes the saving on), however, in the long term the overall system cost will increase.

As outlined Tesla is not a retailer and our ability to manage pricing through bilateral arrangements is limited due to our relatively small capacity level and the fact that Synergy essentially controls the majority of the retail market. This makes it difficult for small generators like us to negotiate an effective bilateral arrangement with Synergy due to its market power.

Draft MRCP Comments

We wish to specifically comment on the significant reduction in the set price for the year and its implications on both Tesla and the market in general.

Network Access Charges
Based upon the current price list of 2011, Tesla is paying substantially higher Fixed Network Access Costs than the per MW value allowed in the Draft MRCP calculation. We would be happy to share these with the IMO on a confidential basis. We believe the Draft MRCP calculation both underestimates the current cost of network access charges and the rate at which this will increase over time.

Insurance Costs
On a per MW basis, Tesla is paying substantially higher premiums for the insurance of its plant. Given we have a peaking station, it is assumed that Tesla would be on the lower risk side of the continuum and therefore feel that the insurance costs are underestimated. Again, we would be happy to share these with the IMO on a confidential basis.

Weighted Average Cost of Capital

We understand the market rules allow the IMO discretion on the 5-Yearly parameters which are used to calculate the Weighted Average Cost of Capital (WACC).

We believe there has been a significant market dislocation since these 5 yearly parameters were set which will allow the IMO to exercise its discretion in regards to the calculation of the market risk premium.

While the mathematical equations suggest that the required return on equity (Ke) has significantly decreased with the reduction in the risk-free rate (rf – proxied by the 10 year Australian Government Bond), there is a strong argument that this is not the case. Equity values have been substantially declining over the last few months, and with no wholesale reduction in forecast earnings, the reduction in value could be attributable to an increased risk aversion or a higher demanded return on equity.

There is also an argument that the yields on government bonds may currently be artificially suppressed due to illiquidity issues and a “flight to quality” as a result of current global economic instability, such that the price of bonds has increased resulting in a fall in nominal returns on “risk-free” securities for reasons other than inflationary expectations which has in turn resulted in a prima facie increase in the valuation of assets (not withstanding their cash flow profiles and operational risks may have been unchanged from prior periods) which from a commercial perspective is difficult to reconcile having regard to current market conditions (Source: KPMG Murchison Metals Ltd Independent Expert Report).

The use of the theoretical WACC to establish the return on capital investment may be misleading at the moment as current input conditions are showing anomalous readings:

- In the current post GFC and Euro-bank environment, borrowing costs are much higher than what is evident in the debt component of the WACC calculation. Although official interest rates are falling, debt funding, particularly to small private sector companies is becoming scarcer and much more expensive.
- Outcomes such as the MRCP pricing, if implemented, will reduce the attractiveness of the WA electricity sector to investors, both from a return and sovereign risk perspective, effectively eliminating the participation by small and medium sized generators. Additionally, larger generators will likely seek more certainty of process before risking capital which may see the only willing investor being government linked entities, again working contrary to the intent and spirit of the WEM establishment.

From a “big picture” point of view, having a 0.6% difference in the pre-tax cost of debt and the post-tax cost of equity does not make sense to an equity investor and will likely prevent any new investment in generation until equity returns normalise. Equity investors require significantly higher than a risk adjusted 9.2% on their equity to make an investment.

Given the artificially reduced WACC inputs, we request the IMO review the inputs and apply a normalisation to the inputs to allow the calculated price to follow the spirit and intent of the formulae.

As outlined the proposed pricing changes have significant implications for both Tesla and capacity providers more generally. The key issue is the size of the movements in the MRCP for the 2014/2015 capacity year. In a capital environment that is complicated and affected by international events a stable pricing regime is critical to provide confidence for debt and equity capital providers to continue to support future growth in the Western Australian energy sector.

Yours Sincerely,

Ben Tan
CEO