



20 December 2012

Mr. John Pierce
The Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

By email to submissions@aemc.gov.au

Dear Mr. Pierce

Potential Generator Market Power in the NEM: (ERC0123)

AGL Energy Ltd. (AGL) welcomes the opportunity to provide the an additional submission to the Potential Generator Market Power in the NEM rule change, specifically in relation to the "Carbon Markets Economics (CME) report for the EUAA on Electricity market power in south Australia" dated November 2012.

AGL notes that, after completing considerable analysis and consultation in relation to the original MEU proposed rule change, the AEMC concluded that 'there is insufficient evidence of the existence of substantial market power to warrant the introduction of a rule that restricts the dispatch offers of generators in the NEM'. AGL supports this conclusion.

AGL has reviewed the report by CME for the Energy Users Association of Australia, in particular Section 3, "The exercise of market power in South Australia" and is of the view that this report offers no new evidence with respect to market power. The author has:

- analysed the available data and reached conclusions based on his own definition of how generators should behave at times of high prices and hence his own definition of market power;
- reached incorrect conclusions, primarily because the analysis has ignored the impact of generator contract positions on bidding behaviour;
- placed undue reliance on spot market outcomes, failing to recognise the importance of contracts in protecting consumers from extreme price events.

We note that the report acknowledges that contract positions drive bidding behaviour but has inexplicably failed to consider the effect of contract positions in the analysis.



The report presents no new evidence that would undermine the AEMC's draft conclusion that a rule change would act as a disincentive for new generators to enter the market, potentially result in a number of perverse outcomes including:

- reducing the long-term reliability of supply to consumers and
- increasing prices as supply fails to keep pace with the growth in demand.

AGL considers that the NEM continues to provide appropriate signals, and appropriate risk management mechanisms, to market participants. It is worth noting that high priced periods in the market are an essential feature of its design, providing both the variability to support peaking plant/demand side response and the incentive to manage demand through contracts, which then drive investment.

If you have any questions in relation to this submission please contact Alex Cruickshank on 03 8633 6026 or Simon Camroux on 03 8633 6967.

Yours sincerely,

Alex Cruickshank
Head of Energy Regulation

Comments on the CME report for the EUAA on Electricity market power in South Australia, dated November 2012

Section 3.2 Evidence of the exercise of market power

The CME paper claims that generators having spare capacity at times of high prices is evidence of the exercise of market power. Spare capacity is defined as the difference between 95% of a generator's maximum output and the generator's actual output in that settlement period. The author assumes that if a generator has spare capacity at times of high prices then they would want to maximise production at times of high prices and if they don't do this they are withholding capacity or offering it at high prices. The author has also failed to include a temporal dimension in the definition of market power.

This conclusion ignores the impact of a generator's contract position on their offers. Generators make offers to maximise revenue not necessarily production. These offers are driven by their contract position (not spare capacity). At times of low prices this generally means maximising production. Generally low offers are made up to the contract level after this generator's offers are based on a price volume trade off to maximise revenue. A generator with a low contract position, (i.e. in the absence of guaranteed annual contract revenue), is exposed to the uncertainty of pool revenues. However if demand were to exceed the total of all generator's contract positions, in a region, then a generator with a low contract position can offer their plant to the pool at higher prices, at lower levels of production than would normally be the case.

This occurred in the summer of 2008 and 2009 when, four unusual circumstances coincided, namely;

- Large consumers in SA choose to not contract with retailers or generators (Refer Major Energy Users (MEU) rule change submission), this meant that they were exposed to pool prices,
- Low contract position for the Torrens Island A & B power stations,
- Drought conditions in the NEM meant in general that higher cost plant was being scheduled due to lack of availability of hydro generation,
- Extreme temperatures driving very high demand.

At times of high demand Torrens Island A and B were required to operate above their contract position and hence given the opportunity to recover annual revenues in a short period of time. This is a design feature of an energy only market and allows all generators to recover a payment for providing capacity above their contracted quantities. This has been discussed many times during analyses of the NEM and most recently by Dr Jenny Riesz:

"Many are surprised to discover that all generators in the NEM make a very significant proportion of their annual revenues during a small proportion of the highest priced periods, and variable renewables are no exception to this. Analysis of historical prices indicates that wind and solar generators receive 20-70 per cent of their annual revenues in the highest priced 20 days of the year." Dr Jenny Riesz, AECOMM, in Climate Spectator 19 December 2012

Impact of high pool prices on consumers

Price in SA can be volatile. The cost of generation in SA under the NEM Rules is generally higher due to the high cost fuel sources employed and the pool price is also



subject to extremely high temperatures in summer that drives demand up. In 2008, due to the widespread drought in Australia, the cost of energy imported into the region was also higher than in previous years.

A Consumer contracted either with a retailer or a generator would be protected from the volatility of prices, albeit at a higher price than the rest of the NEM as has always been the case for SA.

The use of contracts to manage price risk is an integral part of the NEM design. The paper suggests limiting the pool price as a means of protecting consumers but it is ignoring the more effective tools that are available to manage risks in the pool. A well contracted participant is not exposed to the high prices that are a necessary feature of the market.

The paper comments (p17) that the first quarter variability (shown as the difference between contract prices and pool outcomes) is higher than the balance of the year. The author attributes that to a lack of competitiveness. A better explanation is that demand is higher and more variable during this time of the year leading to greater use of higher priced plant. Again, this is managed by customers contracting with generators, which makes more plant available for dispatch at and fixes the price paid by consumers via hedge payments.

Analysis of Contract Prices

We draw your attention to the LYMMCo submission to the Directions Paper, which included a comprehensive analysis of contract prices over the period 2002 to 2012 which shows that higher prices occurred in all regions in all quarters' during the drought, not just in SA.

In most regions including SA, calendar year contract prices, after high prices in 2008 and 2009, in 2010 and 2011 were at the same level as those traded in 2003 and 2004. In real terms the contract prices for 2010 and 2011 were lower than at market start.

This analysis demonstrates that the events in SA in 2008 and 2009 were transitory in nature. This conclusion can also be drawn from the data presented in the CME report itself (pp 14-15), although it is not made by the author.

Contract prices follow pool prices

The paper alternately suggests that contract prices can predict pool prices and that pool price inform contract prices.

Generally contract prices are above pool prices, which is a price for transferring the risk to generators and reserving their capacity. Contract prices also follow pool prices (up and down) except for circumstance that are readily predictable by traders, such as the impact of drought. High price events are not readily predictable and therefore are not included in current contract prices, but will impact on future contract prices due to the higher average price that results.

As discussed above, the drought (not the prediction of high prices) had increased contract and pool prices in all regions in the NEM prior to the time period covered by the CME paper. Once the drought had broken, pool prices dropped to below contract prices once again. The paper states this normal arrangement is somehow a result of participants anticipating the use of market power in SA. The fact that the 2008 contract price increased in all regions demonstrates that this assertion is false.