Macquarie Generation

Corporate Office

34 Griffiths Road
LAMBTON NSW 2299

PO Box 38
HUNTER REGION MC
NSW 2310 AUSTRALIA

Telephone 61 2 4968 7499
Facsimile 61 2 4968 7433
Website www.macgen.com.au
ABN 18 402 904 344
AFSL No: 284379

Steve Graham
Chief Executive
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
SYDNEY NSW 2000

Dear Mr Graham

ATTRIBUTED COMMENTS IN THE AUSTRALIAN FINANCIAL REVIEW

Thank you for your letter of 12 March 2012.

You have asked for clarification of particular statements in an article by Marcus Priest titled "Carbon tax hit threatens price blowout" in the Australian Financial Review on 29 February 2012. For convenience I have repeated below the particular paragraph from the article.

> "If you have a $500 million bill and you have to absorb 20%, so there is $100 million right there and our projected profits this year are $100 million". As a result Macquarie is considering options to stay profitable which include reducing output to increase the price of power in the National Electricity Market. "We have done it in the past to respond to varying market circumstances" Mr Skelton said. "To the extent wholesale prices increase, you would expect it would increase the price to consumers".

The paragraph is not an accurate reflection of my statements or the views of Macquarie Generation.

As you will appreciate the paragraph conflates complex and nuanced aspects of the design and economics of the National Electricity Market and the commercial decision making of its participants, including Macquarie Generation. The National Electricity Market is a gross energy pool in which the physical and electrical necessity of instantaneously balancing supply and demand is managed by AEMO through dispatching energy from the cheapest to the highest priced offer necessary to meet demand. In any settlement period all generators receive the clearing price effectively set by the highest offer dispatched (the "marginal" generator(s)). In periods of peak demand or supply interruption any generator of any material size in the bid stack may have the capacity to "increase" the price by "reducing output" (placing capacity into higher price bands).

The fact that, at times, one or more generators are able to influence the clearing price is a function of the design of the market and not an indicia of market power. I believe that it is generally understood that for a firm to have a substantial degree of market power it must be able to raise prices by restricting output <u>in a sustainable manner</u>. In the National Electricity Market any such power is generally fleeting and Macquarie Generation does not consider that it is in a position to "increase annual average wholesale prices to a level that exceeds long run marginal cost, and sustain prices at that level".

The discussion that I had with Marcus Priest about the impact of the carbon tax on Macquarie Generation was in the context of a different aspect of the commercial context in which Macquarie generation operates. To put it simply if Macquarie Generation experiences a significant increase to its cost base (through a carbon tax) without an off-setting increase in revenues its operations may become loss making. Obviously, acting prudently Macquarie Generation would take steps to avoid such an outcome including firstly by reducing its costs. Macquarie Generation operates two power stations, Bayswater and Liddell. There have been previous circumstances in which the prevailing contract and pool prices were such that Macquarie Generation needed to take steps to reduce its costs including through the reduction of costs associated with maintaining all units in operation. These circumstances may result in, for example, the higher cost units at Liddell power station not being offered to the market.

In my opinion taking actions to reduce costs is the conduct of a prudent business operator, not that of a firm with substantial market power. If higher cost generation capacity not being offered to the market results in higher pool prices that outworking is a consequence of the major structural change to the industry caused by the imposition of the carbon tax and not due to the exercise of "market power".

Yours faithfully

RUSSELL SKELTON 19/3/12
CHIEF EXECUTIVE
AND MANAGING DIRECTOR