

19 May 2011

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

Attn: Paul Smith
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Dear Mr Pierce

AEMC Strategic Priorities for Energy Market Development – Discussion Paper 2011

Alinta Energy (AE) is pleased to have the opportunity to provide comment on the Strategic Priorities for Energy Market Development 2011 Discussion Paper (the Paper). The Paper released by the Commission in April 2011, presents a welcomed debate on those issues facing the market at a time where likely future development is clouded with policy uncertainty, significant technology risks, and financial and investment challenges.

Recently AE expressed concern with the Commission regarding its current work program around rule change proposals and responding to Ministerial Council on Energy (MCE) directions, in particular, the level of overlap within the work program.¹ AE consider the potential overlap within the work program is exhausting and stretching the Commission's resources, potentially creating regulatory risks to the effectiveness of the Commission's findings, and ultimate impact on the development of the NEM.

AE considers that this process provides the Commission with the basis to ensure that the Commission's work program is focused, and has limited overlap.

Moreover, AE encourage the Commission to release to industry, as part of their final report its work program and timetable as presented to the MCE. AE considers this will assist the industry in aligning its resources to better respond to future market developments and in doing so ensure due consideration is provided to each matter.

AE is of the belief the Commission has identified key priorities facing the market, and considers there to be several separate issues to be considered as part of each priority. On balance AE recognise Strategic Priority One as the single most important focus for the Commission moving forward given the significant impact that an unpredictable regulatory environment would have across the entire energy supply chain in the longer term. Be that as it may, AE considers Strategic Priority Three presents an immediate short term priority for the Commission.

AE has structured its comments in response to each of the strategic priorities.

¹ AE SENE Rule Change Submission 12 November 2010.

Strategic Priority One:

"Predictable regulatory and market environment for rewarding economically efficient investment"

Achieving the optimum economic framework for investment in generation and transmission (and distribution) is critical as a result of the forecast capital expenditure requirements for the NEM to meet expected growth in energy demand with less carbon emissions. At present the Commission has noted investment in the development of both transmission and generation for the next five year period is forecast to be in the order of c.\$47 billion.

The National Electricity Market (NEM), since its inception in 1998 has gone through significant changes delivering substantial benefits to market participants and customers. These benefits are predominately in increased reliability and security of supply, with greater competition, and adequate levels of investment in new power generation systems. In providing these benefits, the market has proven to be resilient ensuring efficient and timely investment in network and generation.

As the NEM enters into the next phase of its development it faces significant challenges brought on by:

- an ageing network in need of significant capital spend whilst carrying residual asset stranding risks that network distribution technology may change during the 50 year life of the current investments;
- a shift from historical 'oversupply' of generation capacity available to meet load requirements, to the supply system in need of increased supply options;
- extensive generation investment requirements in all forms of operation (base-load, intermittent and peaking) in order to support climate change policy developments, increases in forecast (predominately peak) demand growth, and replacement of ageing/retiring generation infrastructure;
- rising retail electricity prices;
- climate change policy uncertainty; and
- changes in market participants' access to the global financial markets post the Global Financial Crisis (GFC).

For the Commission, these challenges, and how the Commission looks to augment the present regulatory settings to respond, will fundamentally affect the short and medium term investment attractiveness of Australia's electricity and energy supply chains when compared to international peers. Clearly, where Australia falls behind in this comparison then much needed financial capital is more likely to be invested in other countries, or invested in those projects presenting a greater risk-reward pay off. This potential delay in investment or misallocation of capital will result in significant short term and long term challenges in the form of increased costs in the supply of electricity and energy products to consumers as participants invest in projects which may not contribute to the long term economic efficiency of the market.

Specifically, a review of the current challenges highlights the uncertainty and instability in the existing frameworks largely as a result of external factors beyond the control of the Commission. This was highlighted by the Commission where it recognised *"the delivery of effective market outcomes for energy*

customers depends on a range of other policy settings and market developments which the AEMC is not responsible for.²

AE notes that the policy uncertainty is currently managed by investors with simply delaying or no longer proceeding with planned investments, or investing in opportunities with a pay off structure corresponding to that of a risk profile accounting for uncertainty. AE's concern is that this may erode the competitiveness of Australia's economy in the short term, through reduced reliability of supply in electricity and energy products, and in the long term fundamentally affect Australia's economic competitiveness as the electricity and energy sector plays 'investment' catch-up or is left with sub-optimal assets.

These outcomes at their worst could lead to a reduce reliability and security surrounding supply to end users as well as contribute to increase prices as result of investment in high cost generation technologies and an investors need to recover a higher rate of return on their investment. Furthermore policy uncertainty is likely to diminish the governments' ability to meet its emissions targets, where investors fail to undertake the necessary new investment to either meet demand or replace ageing (predominately coal-fired) generation technologies.

The current penetration rates of renewable generation in the NEM, for example the increase in wind generation capacity in South Australia (SA) in response to climate change developments such as the Renewable Energy Target Scheme, and the recent focus of market participants on gas-fired generation development provide an example of the markets response to current uncertainty. Market participants will only invest in those generation technologies considered to be commercially viable over the investment horizon period (20 years plus). Current technology trends and uncertainty in the political environment has resulted in gas fired and wind technologies dominating the investment landscape.

Continued investment in wind and gas generation technology will alter the current generation mix within in the NEM. In particular, this is likely to result in an abundance of intermediate and peak generation technologies whilst constraining new investment in base load generation. Repercussions of this type investment patterns are likely to be felt throughout the system, in particular:

- In the event of retirement of coal fired generation in light of a price on carbon from the system - higher cost generation technologies operating as base-load generation at times of low demand
- Increased system security and reliability issues where renewable generation technologies such as wind fail to provide to the market the necessary ancillary services required to manage voltage fluctuation or provide ride through capability or 'cold start' services to the market.

While the Commission may argue that these challenges are outside the scope of its responsibilities AE maintains that an important function of the Commission is to inform Australia's policy makers of the long term consequences of short term political decisions.

The Governments intention to put a price on carbon, designed to 'close down' around fifty percent of the current base load generation capacity, together with a development and construction time horizon of at least five years for Greenfield base load investments represents a policy challenge the Commission must

² AEMC Strategic Priorities for Energy Market Development page 11

focus on. As a priority, the Commission must ensure that investment in base load generation occurs. In doing so, the Commission must establish investment framework settings that provide the necessary incentives to market participants in order to proceed with any such investment.

Moreover, the Commission in getting the market settings right is made more complicated by further consolidation of market participants within the NEM in effect reducing the level of competition within the market, and by the fact that given the Commonwealth Government's reluctance to provide reasonable adjustment assistance to heavily affected coal fired generators. AE expects that the NEM may lack the appropriate investment incentives to support a participant making an investment in a 'merchant' base load generating system.

AE understands key feature of the Commissions role within the existing framework is ensuring the market continues to meet the National Electricity Objective (NEO). In doing so the Commission is tasked with the promotion of long term investment, operation and use of the electricity system having regards to consumers with respect to:

- price, quality, safety, reliability and security of supply; and
- the reliability, safety and security of the integrated national electricity system.

AE agrees with the Commissions definition of achieving an economically efficient energy market³, one in which the NEO is achieved. In recent times the market has been faced with a number of new developments, which could be considered a direct response to the public policy objective of lowering the carbon intensity of the electricity system rather than making amendments to the National Electricity Rules (NER) in order to better meet the NEO.⁴ AE considers the Commission, in its role as advisor to the Ministerial Council on Energy (MCE), is best placed to articulate the balance required between the above competing objectives, and the necessary regulatory and market framework required.

AE maintains that a fundamental objective of the Commission is to balance regulatory certainty with making prudent and reasonable changes to the market rules that facilitate market participants delivering electricity and energy products to consumers through assets and business models that minimise the costs of supply. From AE's perspective, the objective of regulatory certainty has to be linked to the technological and commercial life of the assets within the NEM, that is, the Commission when considering proposed rule changes or MCE directions must consider impacts on existing assets, and ensure that the proposed change has sufficient strength to sit unchanged for at least 20 years. Moreover, the need for changing the market parameters in response for change must pass the threshold that the benefits to consumers from the change are greater than the benefits of alternative approaches for at least 20 years.

AE therefore urge the Commission as part of its work program for the forth coming 24 months undertake a broad analysis of the current impacts as a result of policy uncertainty on the market for consideration of the MCE. This analysis should include a comparison of the projected generation requirements and the current 'pipeline' of committed and advanced proposals, the retirement of existing plant and the likely impacts both are to have on the security and reliability of supply across the system, a review of the

³ AEMC Strategic Priorities for Energy Market Development page 12 - 13

contract market beyond the indicative introduction dates for a carbon pricing scheme and market participants ability to obtain the necessary finance in order to support future generation investments. AE recommend this analysis be completed sooner rather than later so that the outcomes may be fully considered by all levels of government and industry.

Strategic Priority Two:

"Building the capability and capturing the value of flexible demand"

AE recognise the work completed by the Commission as part of Stage 1 and 2 into the *Review of Demand Side Participation (DSP) in the National Electricity Market*. AE understands the review is now entering in to its third stage, with the aim of identifying the market and regulatory arrangements that would enable the participation of both supply and demand side options in achieving an economically efficient demand/supply balance in the NEM.

Whilst AE can foresee some merit in the introduction of broader DSP within the market, it considers the proposal largely to be politically driven in nature, consistent with the development of similar policies designed to increase the level of renewable generation within the system. Furthermore whilst there has been substantial work done to date by the Commission and industry participants there still remains a considerable amount of work to be completed before the true value of DSP within the NEM is realised.

Despite AEs concerns of further politically drive market developments, AE considers the decision by the Commission to broaden the review to incorporate all arrangements that impact on the energy supply chain as an appropriate means to achieve an economically efficient outcome. In doing so the Commission will be better positioned to ensure any framework developed as a response to the review better assist in achieving the NEO. Moreover, whilst AE considers the development of a national scheme as the appropriate response for DSP within an integrated electricity market, it believes a DSP framework must not render market distortion as a result of its implementation. Nor should it provide for uncommercial incentives favouring its operation over existing generation activities.

AE considers the existing energy market frameworks that support the contract arrangements and operation of the spot market as well established markets with considerable flexibility and sophistication.⁵ Work therefore in developing and implementing an appropriate commercial and regulatory DSP framework should revolve around an understanding of the end users needs in relation to altering their energy use. This requires the market to have an understanding of not only the technological developments required but also an understanding of how best to educate end users in the application of new technologies. Failure to incorporate the necessary learning is likely to render any costs incurred in the installation of such equipment as sunk, as end users fall short of fully utilising the equipment.

Once an appropriate technology response has been developed the Commission must ensure the incentives of all participants in the energy supply chain are appropriately aligned in order to achieve the

⁴ AE provided a similar response to the AEMC Rule Change for the proposed inclusion of Scale Efficient Network Extensions

⁵ AE is of this opinion even though it has noted previously concerns regarding the liquidity present in the contract market at the time of making this submission. AE is of the belief the liquidity in the contract market is likely to increase once a decision to place a price on carbon is established.

most efficient outcome. Specifically, maximising DSP benefits to the consumer and the market overall, will prove to be difficult where network businesses are able to:

- operate under a planning standard that encourages over building of the network
- set prices by having regard to recovery revenue caps designed by a cost to serve building block approach
- set prices utilising a "fully distributed cost" pricing methodology.

Should the market continue in its current form it is likely the DSP framework will result in an otherwise substandard outcome.

Strategic Priority Three:

"Ensuring the transmission framework delivers timely and efficient investment"

As noted previously, AE considers Strategic Priority Three presents an immediate short term priority for the Commission. The Transmission Frameworks Review (TFR) presents an opportunity for market participants to clarify and resolve a number of issues within the existing framework, including the connection arrangements facing generators, impacts of network congestion and the current economic regulation of networks. AE recognised the work completed to date by the Commission as part of the TFR and as a consequence consider the majority of the issues presented by the Commission in the Paper to be covered as part of the review.

AE have been, and intend to continue their participation within the TFR. Subsequently AE will take the opportunity to provide further comment on its position in relation to the transmission framework in the ensuing Directions Paper, Interim and Final Reports.

Should the Commission wish to discuss the contents of this submission please contact James Reynolds on 07 3011 7646 or Lance Brooks on 07 3011 7667.

Yours sincerely

A handwritten signature in black ink, appearing to read "GS", written over a faint, larger signature.

Gary Stanford
Executive Director Wholesale Energy
Alinta Energy