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13 May 2011

Dear Paul,

Submission Strategic Priorities for Energy Market Development 2011

TRUenergy welcomes the opportunity to provide comments on the Australian Energy Market Commission (AEMC) Strategic Priorities for Energy Market Development.

Overall TRUenergy is pleased to see the AEMC provide guidance on its views to the energy sector. This is especially important during the period of significant uncertainty created in part by meeting the challenges of climate change.

Our submission addresses the strategic priorities as identified by AEMC, and we provide comments and suggestions for further refinement. We want to be an engaged industry participant and would welcome further dialogue with the AEMC on the issues relating to the development of energy markets.

Market Overview and Key Challenges

Impact of climate change policies on the energy sector

The AEMC notes that pressures induced in part by the Government's climate change policies are likely to require a change in the generation mix and may also be reflected in higher prices for end user consumers. TRUenergy agrees with this assessment and while to a significant extent these pressures are outside of the AEMC's ability to control, there is some ability of the AEMC to temper the effects to bring about an orderly transition, as described below.

Demand growth

Meeting demand growth is required to support ongoing economic development. For Australia to remain a first world nation it is essential that investment in generation and networks continue to be timely. It is worthwhile noting that the investments made in previous decades in both generation and networks have facilitated Australia to achieve significant economic growth. The impact of the perception of poor electricity reliability on Australia's gross domestic product in 10-15 years could be significant. The challenge for the AEMC is how to ensure that this investment is made at the right time but at least cost to underpin Australia's continued prosperity.

Rising prices

TRUenergy agrees with the AEMC that there are multiple factors contributing to increasing prices for end use consumers and that prices are expected to increase in future due to a variety of causes.

Market resilience

Overall the energy market has delivered a high degree of market resilience. Electricity is supplied within reliability standards, investment by the private sector in both generation and the retail market is occurring. Market default events have been rare and have had a limited impact on the market. Over time more financial instruments have become available to allow participants to manage market price risks. Overall the market is broadly delivering the expected outcomes. Given that the market is fundamentally working, but is to face some significant challenges in the future the industry needs to be cautious in demanding significant and rapid change to existing frameworks, as this may have unintended consequences.

Overall comments regarding Strategic Priorities

It would be helpful to understand what time period the AEMC is considering for the strategic priorities. The sector is characterised as having long dated assets with life spans over 40 years. As a minimum we would expect that the strategic priorities are robust timeframe to support long term decision making in the sector.

Furthermore as correctly noted by the AEMC there are a number of external factors having a major influence on the sector. The AEMC is limited in responding to these factors by either advising or influencing relevant government agencies. We recommend that the AEMC differentiate its work programme into actions that the AEMC can specifically undertake and implement and into areas that the AEMC can influence but has no accountability for delivery.

Strategy Priority #1: Predictable regulatory and market environment for rewarding economically efficient investment.

TRUenergy agrees with the AEMC on the strength of the current energy market frameworks and see this as the AEMC broadly endorsing the current market structure.

The AEMC has noted three concerns about the current frameworks and policy environment. However the AEMC is limited in its ability to address some of these concerns.

Policy Settings

As previously identified the numerous changes to government policy in a number of areas have a direct impact on the markets ability to make economically efficient investments. TRUenergy believes that policy uncertainty is the largest impediment to the investment decision making process. We also note that the Energy White Paper is once again under development and are anticipating a clear policy direction for the energy markets from this process.

Implications on contract market of the changing market structure

The AEMC raises the risk that changing market structure (via vertical integration) may reduce liquidity in the contract market. This issue was reviewed in detail by the Energy Reform Implementation Group and determined to not be a significant concern. TRUenergy feels that this risk maybe over estimated for the following reasons: contract market liquidity is increasing, vertical integration is not a perfect hedge; market liquidity is more likely to reduce due to uncertainty; the difference between the availability of instruments versus the pricing of instruments.

Firstly figure 1 shows that contract market liquidity has been increasing since the privatisation of assets and this has occurred in the context of a vertical integration strategy being pursued by a number of companies.

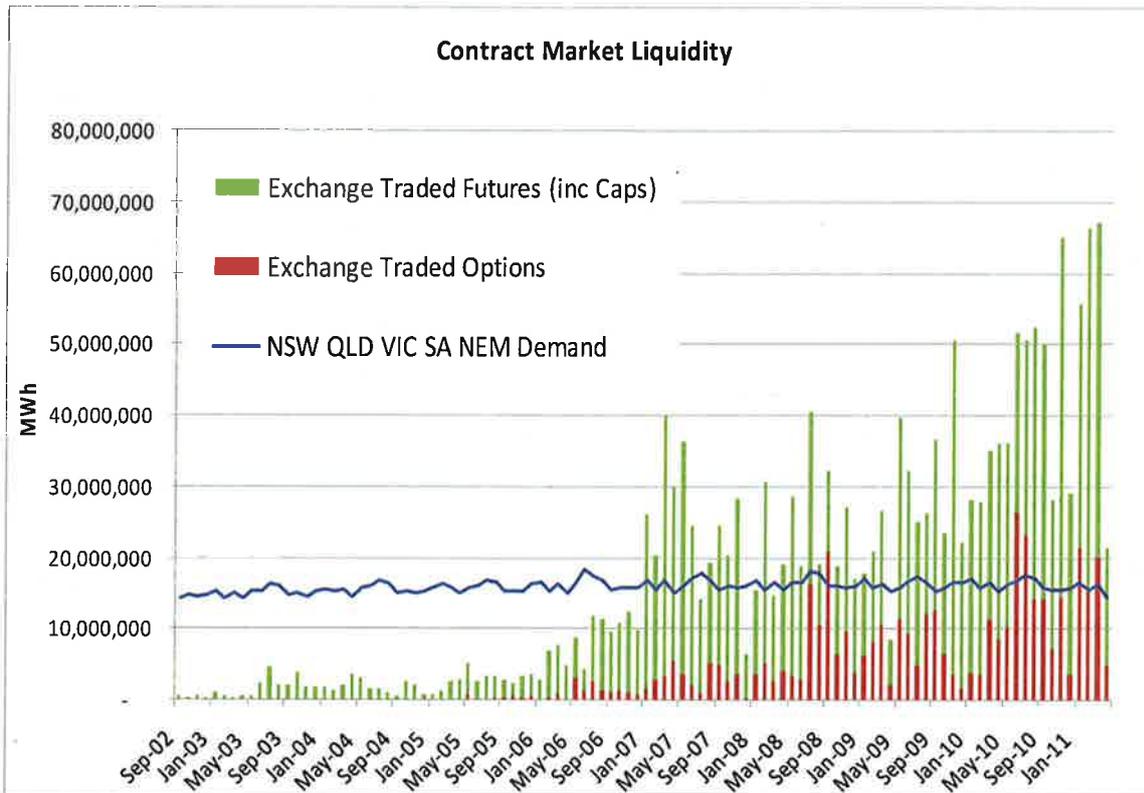


Figure 1: ASX traded volumes Source: d-cypha trade

Secondly a vertically integrated company is not a perfectly hedged company, the assets and liabilities have different durations and geographies. Where an organisation is long on generation at a particular location and time, they may be correspondingly short at another time and location. In effect this means the vertical integrated generator-retailer acts a "quasi market maker" for the sector as they can be on both sides of a bid and offer (as the vertically integrated generator-retailer can price the opportunity cost of both buying and selling). Market makers perform an important function in modern markets, providing transparent prices and liquidity.

Liquidity issues are driven by uncertainty and the inability to value contracts. Recent experience in major international capital markets saw liquidity decrease significantly in light of the initial confusion and uncertainty created during the global financial crisis. Anecdotally TRUenergy also has noticed reduced liquidity in the Australian electricity financial markets at times in response to the climate change debate.

The TRUenergy trading desk transacts a significant number of financial contracts each year for a range of terms and in a number of regions. As a general rule we will price and enter into a wide range of contracts subject to the organisations risk management policies. Our experience indicates a willingness to transact, but the major stumbling block is not the availability of contracts but the pricing of financial instruments. Parties often do not agree on the value of the contract and this is a result of the different valuation methods used in the sector. Valuation methodologies evolve and mature over time. As can be seen in figure 1 the increasing number of options traded would indicate that counterparties are able to agree on the value of an option. Over time as market experience increases a wider range of instruments will be able to be valued effectively by counterparties.

TRUenergy feels that competition aspects of market structure are effectively managed by the ACCC and do not see a role for the AEMC in this area.

Finance post the GFC

The AEMC raises a concern about the ability of financing post the GFC. International capital markets are continuing the finance a number of infrastructure projects around the world, therefore funds exist. So the key issue is how to attract financing to Australia electricity sector. In our experience, the main concerns with financing for the sector are more a function of uncertain government policy around

climate change as opposed to the actual availability of funds. The uncertainty will be placing upward pressure on risk premiums for both debt and equity providers.

We note concerns that a number of merchant generators are not able to finance generator due to the inability to forward sell output at a price that reflects the cost of the investment. This is in part due to the oversupply of base load generation in the market. As demand "soaks" up the excess base-load generation and carbon policy is more settled one would expect base load prices to increase to a level commensurate with the cost of new build. A further factor compounding the issues for merchant generation is that the end use customers maybe reticent to enter into long term power purchase contracts, instead preferring to remain on the spot or shorter terms contract markets.

Recommended focus for the AEMC – removing barriers to entry and improve operation of the market

As noted above the ability for the AEMC to make a substantial differences in the above areas is somewhat limited, however the AEMC can focus on removing barriers in both the generation and retail markets as well as improving the operation of the market.

TRUenergy recommends that that strategic priority #1 is reframed to emphasise the focus on removing barriers and improving market operation.

Some specific programmes for work in this priority would include:

- Facilitating the flow of information in the market to reduce information asymmetry issues;
- Improving the efficient use of capital in the market;
- Continuing to promote the deregulation of retail prices, allow for innovative tariff arrangements and measures that reduce the cost to serve retail customers;
- Harmonise the transmission and distribution network planning and operation across the NEM;
- Streamline the connection process for generators;
- Consider improvements to methodologies for providing MLF stability, unstable MLF over time (5 years plus) have a significant impact on the viability of a number of generation projects and increase risk premiums (potentially inefficiently) around generation development; and
- Support AEMO in improving a number of processes and procedures to improve efficiency.

This list is neither complete nor prioritised but is intended as an example of specific actions the AEMC can undertake to develop a predictable regulatory and market environment for rewarding economically efficient investment. The work identified in the market resilience work-plan would also fit into this strategic priority.

Strategy Priority #2: Building the capacity and capturing the value of flexible demand.

TRUenergy notes this strategic priority only includes DSP3 and query if this work in of itself is actually a strategic priority. This is surprising given that the AEMC identified rising prices as a challenge for the industry. The current wholesale market arrangements appropriately take a competitively neutral approach to demand management (ie. it can participate in the market on the same terms as suppliers). Further efficiencies on the demand side will be most likely found by focusing on achieving retail price deregulation and optimising customer transaction costs around network connection and avoided network costs.

Strategy Priority #3: Ensuring the transmission framework delivers efficient and timely investment.

While not disagreeing with the focus and importance of this work we feel that this is actually a subset of strategic priority #1 and recommend that it is included in that strategic priority.

Alternative strategic priority #3 – Development and integration of energy markets

Given that the AEMC is also responsible for gas markets, the issue that it is not included in any of the strategic priorities is concerning. The proposed monitoring and understanding of the gas markets by the AEMC is understandable at this time, but this has a short time duration. The initial monitoring is the first step in an ongoing programme of work. We propose that the AEMC develop an alternative strategic priority that seeks to develop and integrate energy markets. A major consideration that could fall under this priority is the impact of increasing amounts of gas fired generation and how the impact of increasing gas demand for this generation can be met through investment and operation of the gas transmission network.

Finally TRUenergy thanks AEMC for the opportunity to provide input into a significant body of work and looks forward to working constructively with AEMC to improve the energy markets. Please feel free to contact me on (03) 8628 1632 should you wish to further discuss this submission.

Yours Sincerely,

A handwritten signature in black ink that reads "Lana Stockman". The signature is written in a cursive style with a large initial "L".

Lana Stockman
Manager, Wholesale Regulation
TRUenergy

