Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235
www.aemc.gov.au

17 November 2011

Dear Mr Pierce

Potential Generator Market Power in the NEM

The Private Generators listed on the side-bar welcome the opportunity to make a submission in response to Australian Energy Market Commission's (AEMC) directions paper on the National Electricity Amendment (Potential Generator Market Power in the NEM) Rule 2012.

This submission provides comments on the proposed assessment framework and general perspectives on the Major Energy Users proposed rule.

Proposed assessment framework

The Private Generators welcome the AEMC's comprehensive framework to assess market power in the NEM.

In particular, we support the AEMC's position on short-run and long-run costs in the context of defining workable competition. The AEMC has articulated a number of important concepts which we consider are wholly consistent with the market design, as intended and as functioning, and consistent with real-world financing.

We also support the AEMC's concept of substantial market power, in-principle. The concept of substantial market power is preferable in that it acknowledges the role of transient market power and price spikes as a feature of the market. These conclusions on market power are consistent with existing case law and the market's design.

Overall, the framework is conceptually sound; however, a number of concerns remain which should be taken into consideration to ensure its sound application.

Definitional issues

First, there are some definitional concerns. The inclusion of "*able or likely to be able*" in the definition of substantial market power is concerning and would require significant foresight on the part of the assessor in order to be of any substantive value. Additionally, it is concerning as it hints at pre-emptive intervention in the absence of actual evidence of the misuse of market power. We therefore caution

Private Generators:

AGL Energy

Alinta Energy

Energy Brix

InterGen

International Power GDF-Suez

LYMMCo

NRG Gladstone

Origin Energy

TRUenergy

PO Box 5003
Alphington
Victoria 3078

against the use of forward looking analysis (the outputs of which are inherently imprecise and uncertain) as the basis for regulatory intervention.

The definition of market also requires further consideration. The market can, and should, be conceived in two ways. First, the NEM (spot market) and second the broader market.

The broader market the NEM sits within is less easily definable but requires careful consideration as it is a primary driver of investor decision-making. This includes:

- the competitive contracts market – derivative and bi-lateral contracts;
- retail markets – which of themselves create additional build incentives and constraints on market power for vertical integrated companies;
- transmission and distribution networks;
- competition from other fuels, including gas;
- embedded generation; and
- commodity markets more broadly.

While we appreciate that the broader market is difficult to limit, and complicates the analysis, it is an essential part of an investor's decision-making framework. Hence, any discussion and analysis, including modelling, needs to be considered in the context of this broader market.

The timeframes proposed by the AEMC to measure substantial market power are also concerning. Limiting the threshold to spot market and contract market outcomes over a period of between one and three years is insufficient and will likely misrepresent the structure of the market.

The long-run is inherently difficult to assess and hence attempts to capture dynamic responses over the long term are fraught with difficulty. The calculation process becomes more difficult if an inappropriate timeframe is used.

The NEM itself has only been in existence for over a decade, which is of itself not necessarily consistent with long-run measures especially given the nature of electricity supply and consumption and the asset base. However if a period needs to be nominated, a period of ten or five years is more informative than one or three.

Barriers to entry

Second, we welcome the AEMC's analysis indicating that the issue of barriers to entry requires consideration. The Private Generators consider the identification of barriers to entry is a critical component of the analysis. Arguably, identification of barriers to entry would be a pre-condition to further analysis given material barriers to entry form a pre-condition to market power arising and being misused.

We note that the NEM record on new entry seems to directly undermine arguments suggesting such barriers exist and therefore dilutes arguments purporting that market power is a problem in the NEM. Notably, the NEM history of new entry needs to be comprehensively considered when reviewing the issue of barriers to entry.

We note further, that the analysis has highlighted the issue of strategic barriers to entry and potential deficiencies in the transmission investment frameworks. With regard to the latter, if there are genuine concerns that the transmission framework is leading to inefficient price separation, than that should be considered explicitly.

With regards to the issue of strategic barriers the Private Generators are concerned by the commentary which suggested that there are an "ideal" number of high priced events. Furthermore, we are concerned the analysis may seek to distinguish between "real scarcity" and "artificial scarcity". This is a path which has been previously investigated and which the Private Generators consider is flawed.

LRMC (long-run marginal cost) approach

We understand the value of conducting modelling to inform the analysis. The Private Generators support this approach at a general level. However, we do not believe there exists a single "white line" LRMC test which provides a justifiable basis for intervention and we note the LRMC approach requires significantly more detailed articulation.

The approach seems to attempt to use an optimised LRMC best suited to a regulated environment, where future investment is more readily identifiable, to measure the cost of bringing forward future investment increments.

To have traction with industry, the Private Generators suggest the AEMC needs to use the LRMC required by an investor in order to bring on the marginal plant in the NEM. This would effectively be the levelised cost of investment in a single gas-fired peaking plant. Such an analysis may be captured by the AEMC's proposed approach, but if not, it should supplement, if not lead to the revision of the AEMC's approach.

As it relates to the analysis, we note that both forward-looking and historical models are of limited value in isolation. For instance, it is unclear what a retrospective analysis that indicated a perceived issue in year X would provide. It certainly does not provide a basis for regulatory intervention and ultimately is just as likely to indicate that outcomes vary over time as expected in a dynamic market.

A forward-looking indicator is inherently subjective and based on limited assumptions. For example, it needs to assume a future technology mix and forecasts of future demand. Therefore, it can only be inaccurate. As such, while informative the Private Generators consider that it does not form a basis for justifiable intervention.

SSNIP

The SSNIP is an informative market definition tool but appears biased towards narrow markets, regionalisation of the NEM, and single products. Given the low hurdle rate provided by the AEMC, the SSNIP may incorrectly raise concerns that are unwarranted. Caution should be exercised in the use of the SSNIP in the same manner as is the case with any LRMC modelling. It also does not provide a basis for intervention or changes to market design.

<u>Perspectives on the MEU proposed rule change</u>

The market continues to deliver efficient outcomes

The Private Generators do not consider that the MEU have provided evidence to substantiate their market power claims or justify such a significant redesign of the NEM.

Wholesale electricity prices remain competitive and, in some jurisdictions, are at levels which undermine financial viability for some generators and at present do not justify further investment.

For example, recent concerns raised by the Queensland Government contributing to the merger of Stanwell and Tarong, and low prices in Victoria.

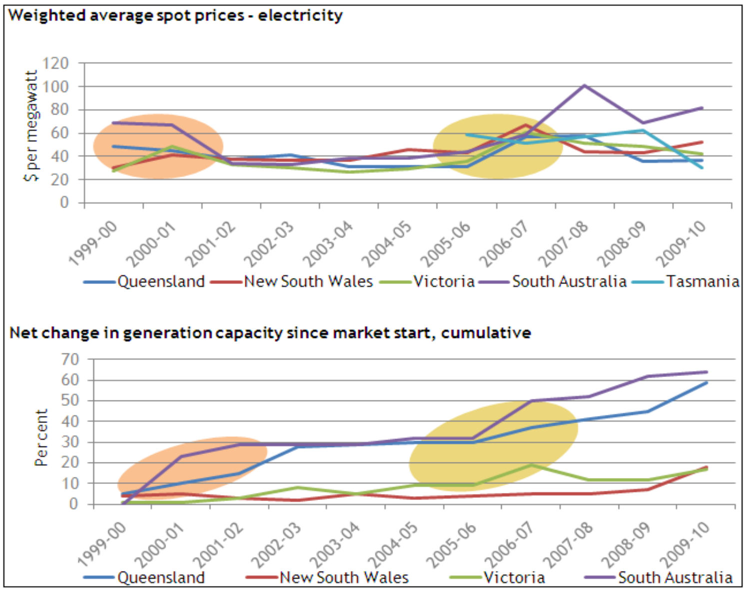
Contract markets remain strong. While contract liquidity is not an end in itself it is an important part of the wider market. As it stands the contract market is comprised of multiple participants and intermediaries. The contract market is mature and provides sophisticated risk management options to participants. Additionally, bilateral contracts tailored to the needs and circumstances of individual generators, retailers and large customers are an important feature of the market.

Consumer concern regarding high prices is not driven by wholesale energy price increases. The Private Generators note that climate change policies, renewable energy initiatives and network investment costs are the primary contributing factors to recent – and forecast – price rises. The appropriateness of these outcomes is not a matter for this submission but should be taken into consideration by the AEMC.

It is important to note that the market has a strong history of new investment driven by the private sector. This includes both generation and retail, including in South Australia.

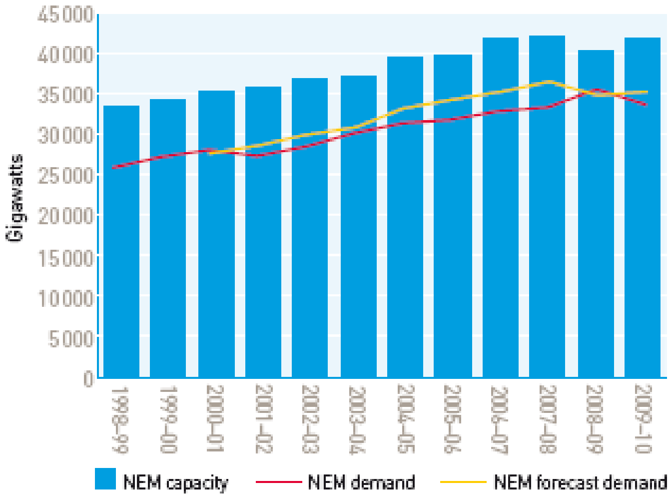
While it is expected that entry and exit decisions will vary over time and jurisdiction, and that price cycles, in both retail and wholesale, will affect those decisions and in turn profitability, there is scant evidence to suggest the market is not efficient. The Private Generators consider the current market structure, without intervention and distortion, has delivered and will continue to deliver effective competition and reliability of supply. This is aptly demonstrated in the following diagrams produced by the Australian Energy Regulator (AER).

First, new generation is informed by price changes. The diagram below illustrates the market is effectively delivering additional supply when price outcomes warrant it. This is not to suggest that price increases are the only trigger for new entry or indeed that generation is the only method an investor may use to capture value and increase competition. However, it does demonstrate that step changes can be expected when required and that generation is responsive to price rises.



Second, the market continues to provide capacity in excess of actual and forecast demand, noting that forecast demand is generally in excess of actual demand and a trigger for intervention by the

Australian Energy Market Operator. This clearly indicates that concerns regarding ongoing capacity have not been an issue since NEM inception.



The Private Generators consider the current design works well and the MEU perspective that the market is flawed and that dominant generators can drive sustained high prices is unsubstantiated.

The market is already sufficiently regulated

No evidence has been provided to suggest the market is not already sufficiently regulated and framed, so as to promote efficiency. The AER, AEMO, AEMC, Australian Competition and Consumer Commission (ACCC) and various state bodies all have a role to play in establishing strong market governance arrangements.

In particular, the ACCC's role and the AER's (as industry regulator) active engagement ensure a level of scrutiny arguably in excess of many industries. Furthermore, given the focus on the electricity sector generally the threat of political or policy intervention is an active deterrent which should not be underestimated.

The Private Generators consider the existing regulatory arrangements are appropriate and that there is an absence of compelling evidence for reform or regulation. It appears any arguments in favour are based on theoretical preferences and not practical outcomes that have any long-run bearing on efficiency or consumer welfare.

The MEU proposal would reduce efficiency

The MEU's proposal is fundamentally inconsistent with the NEM framework and would have a lasting negative effect on the market by:

- creating an inhospitable investment environment;
- being inconsistent with NEM framework;
- impeding new entry;
- promoting a fundamental and disruptive change to the market; and
- undermining price discovery.

Investment in long life, significant cost infrastructure in a competitive market requires a significant appetite for commercial risk. This is a risk worth taking when a proponent has the expectation it can achieve its return over the life of the asset. As the proposal creates additional investment uncertainty it will be noted by potential investors and will without doubt impair the investment environment if it proceeds.

The current market was designed with the expectation of high price events and therefore to remove their impact on the market is not consistent with the expectations of investors, contract counter-parties and inconsistent with the rational underpinning changes to the reliability settings recommended by the Reliability Panel and endorsed by the AEMC.

New private investment in long term significant cost infrastructure requires a degree of stability in the core design of the market. The mere fact that this proposal is being entertained, notwithstanding the appropriate due diligence by the AEMC, is a source of unease and uncertainty for owners and new investors.

The proposal itself introduces a level of complexity and subjectivity in determining dominant generators and requires reliance on price data that will be subject to debate. It also undermines price discovery by introducing an artificial price barrier that can act to mask true price signals. It is difficult to see how the operation of the market could remain in place, let alone be improved, as a consequence of this rule change. The fact alternative market forms were raised at the public forum suggests stakeholders are aware of this.

The MEU proposal is a risk management tool not a market power issue

What is clear from the MEU's proposal is the desire to alter the market's dynamic to minimise risk exposure for a specific category of participants. The introduction of a price cap would have the effect of replicating cover for price risk without large consumers needing to implement hedging strategies or enter the retail market.

In the view of the Private Generators the Administered Price Cap, Market Price Cap and Cumulative Price Threshold already cap price outcomes for the purpose of risk mitigation. Should customers seek an additional level of risk management to suit their risk appetite they should either seek the certainty of competitive retail prices or appropriate hedging contracts to mitigate their exposure to the market.

Additionally, we note the decision-making of generators formed a notable part of the discussion during the AEMC's public forum. As such we encourage the AEMC to give consideration to the role played by the risk management decisions made by the proponent's affected members. Given statements made at the AEMC's public forum implied that those parties hedging decisions underpinned much of their concern, we believe this is likely to illuminate the analysis and should be considered.

In that regard, we reiterate the view that the MEU proposal is not a proposal to address market power. We suggest that the MEU's proposal is a risk management tool advocated by participants who have made poor risk management decisions in affected periods.

Technical papers

At the AEMC public forum the prospect of the AEMC releasing a technical paper on the proposed LRMC approach was broached. We seek a commitment from the AEMC to provide such a paper should its proposed approach not take account of the issues raised in this and individual submissions.

Conclusion

The Private Generators thank the AEMC for the thorough manner in which it has approached this rule change. We also welcome the AEMC's informative and logical perspectives on workable competition, price spikes and market power. These perspectives need to translate to the next stage of the process. We also encourage the AEMC to address the concerns we have outlined, particularly, how the analysis will be put into practice and how intervention would be justified.

The Private Generators offer our assistance going forward, and continue to encourage a quick decision on this matter as uncertainty regarding the possibility of a significant change to market design is not ideal for existing market participants and for new investors.

Yours sincerely,

(Dr) Harry Schaap
(on behalf of the listed generators)