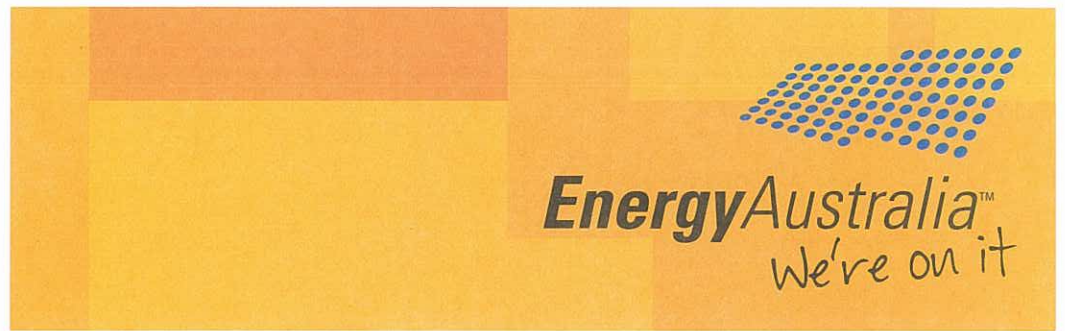


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5 September 2007

Dr John Tamblyn
Commissioner
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

john.tamblyn@aemc.gov.au

Dear John,

Approach to claims for Compensation due to the Application of an Administered Price, VoLL or Market Floor Price - Chapter 3, Clause 3.14.6 of the National Electricity Rules

I am writing to you to express EnergyAustralia's concern regarding the above compensation provisions under the National Electricity Rules (NER or Rules) following an event where the cumulative price threshold (CPT) is exceeded and administered price caps (APC) and floor are invoked.

Concerns regarding the existing approach to compensation

These concerns have been highlighted by NEMMCO's recent briefing paper on the Operation of the Administered Price Provisions in the National Electricity Market (NEM). That paper outlined the operation of the rules during and following an administered price cap and, in particular, noted that the value of energy settlements for a market generator is determined by the spot price at the regional reference node. The paper also noted that during an administered price period, some generators may be dispatched in offer bands that are priced higher than the administered price cap, which triggers a right to claim compensation from NEMMCO.

As you would be aware, where a claim for compensation is made, the Australian Energy Market Commission (AEMC) determines whether the circumstances warrant the payment of compensation and the amount of any such compensation following the receipt of recommendations from a specially convened panel. EnergyAustralia is very concerned that the Rules do not provide appropriate parameters for determining the extent to which compensation should be paid. The Rules do not, for example, direct the panel and the AEMC to ensuring that the generator recovers its costs in a similar way to that provided for in clause 3.12.11 of the Rules when the reserve trader provisions are invoked. The Rules merely provide for the panel (and presumably the AEMC) to take into account the surrounding circumstances, actions of relevant

registered participants including NEMMCO and the difference between the spot price paid to the generator and the generator's dispatch price. This lack of specificity is likely to lead generators to claim compensation up to their bid price and this is of particular concern to EnergyAustralia. These concerns are elaborated upon further below.

Rationale for Compensation provisions

It is EnergyAustralia's understanding that the compensation provisions were initially included in the National Electricity Code (and subsequently replicated into the NER) to allow generators directed into the market by NEMMCO the opportunity to seek a determination if they were dissatisfied with the use of the spot price alone for energy produced during the period of the direction. The compensation provisions were aimed at providing generators with an assurance that their costs would be covered, while retaining market revenue if required to generate, replicating the breakeven decision a generator might take in making the decision to bid into the market.

EnergyAustralia believes the administered price provisions of the NER are an important component of the NEM's safety net, which operates when triggered to limit participants' exposure to the wholesale spot market during periods of sustained high prices. As the market is quite volatile such sustained high prices can result from both normal and abnormal market conditions, and without these provisions the market would experience substantial financial stress.

Under normal market conditions high prices are expected to occur from time to time due to the impact of transmission constraints, weather induced demand spikes and potentially, generator bidding patterns. Under normal market conditions market participants are able to hedge against the vast majority of trading risks through the purchase of hedge contracts.

Abnormal market conditions like extreme natural disasters or major industrial action makes mitigating risk for participants with a large exposure financially challenging, especially when contracts fail through the exercising of force majeure by generators. The options for risk mitigation by retailers following such events are very limited.

Implications of determining compensation on basis of bid prices

It is EnergyAustralia's view that the current Rules governing the compensation due to the application of the administered price, VoLL or market floor price (clause 3.14.6) would expose retailers to material risk if those provisions allowed bid prices to be the basis for compensation. EnergyAustralia is also of the opinion that it would be open to generators who suspect the CPT could be exceeded to rebid their offer prices to VoLL in anticipation, thus gaming the Rules and, in effect, make the CPT process ineffective. This ability for generators to exercise market power under the current compensation provisions is of great concern to EnergyAustralia.

Potentially, retailers could be required to pay generators substantial compensation. As these costs are recovered outside of the spot price, they are not hedged by typical forward contracts. Following the invoking of the APC, and in the event a generator is successful in its claim for

compensation based on bid prices under the NER, retailers may be exposed to extreme clearing prices for 100% of their demand, rather than the small percentage of exposure for a prudent retailer outside of the APC period.

EnergyAustralia could pass through compensation payments to commercial and industrial customers and possibly through to regulated customers in EnergyAustralia's network area through a price change event under the current regulated retail pricing determination. Other than the time this might take to achieve (from several months to a year or more) EnergyAustralia believes this is a cost that customers should not be required to bear. Simply passing on to consumers the cost from a monopoly rent is not in line with the NEM objective. Neither is a retailer bearing such a cost. EnergyAustralia believes that if the current Rules were applied in this way it would lead to an inequitable and unjustified outcome, inconsistent with the NEM objective.

Given the high rolling weekly cumulative price in recent months EnergyAustralia believes there is a chance that the CPT may be exceeded and an APC period may commence. EnergyAustralia is concerned that the current compensation provisions have the potential to expose retailers to additional significant market risk and, if triggered, they will have a detrimental effect on the market.

EnergyAustralia appreciates that no determinations under the compensation provisions have yet been made, however we believe it is important to highlight to the AEMC the extreme financial burden any compensation that NEMMCO pays in accordance with an AEMC determination may have on retailers in the regions affected by the imposition of an administered price period.

Appropriate approach to compensation

EnergyAustralia believes the provisions for compensating constrained-on generators during an APC are unclear and lack transparency, and should not be allowed to lead to a pay at offer market, where by participants' current financial hedging arrangements provide no protection. As currently drafted, the Rules are not prescriptive on how compensation is calculated; leaving the determination of what is a 'fair and reasonable' amount of compensation to the panel's discretion (clause 3.14.6(e)).

EnergyAustralia believes claims by generators for compensation due to the application of the administered price, VoLL or market floor price should be evaluated by the specially convened panel and the AEMC on a cost recovery basis in a similar way to that which applies to reserve trader directions.

EnergyAustralia has commenced work on the analysis to support a formal Rule change. However should an administered price cap apply prior to the determination of such a rule change, EnergyAustralia would urge the AEMC to ensure that any determination of compensation is carried out in a transparent manner in consultation with parties likely to be affected by a compensation determination.

EnergyAustralia notes that the AEMC Reliability Panel is looking at the level of the CPT in its comprehensive reliability review, but its terms of reference do not extend to the full complement of Rules related to the operation of the CPT, including the compensation provisions.

Whilst EnergyAustralia will seek to work with other participants on an appropriate rule change, it is possible that the varying interests of parties will prevent an agreed market approach being developed within a reasonable time frame. For this reason EnergyAustralia is currently developing a Rule change proposal for consideration by the AEMC which it plans to lodge in the near future.

I would be happy to discuss and elaborate upon any of the matters raised in this letter. Should you wish EnergyAustralia to discuss these matters further please call me on 02 9269 4911.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Mike Bailey', with a stylized, cursive script.

Mike Bailey
Executive General Manager Retail