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

Dear Mr Pierce

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

Macquarie Generation welcomes the opportunity to provide comment on the AEMC's first Strategic Priorities Discussion Paper, as published on 1 April 2011.

Macquarie Generation considers that the AEMC has accurately described some of the key challenges for the energy sector and we endorse the proposed work program as outlined in the Discussion Paper. The three strategic priorities are quite rightfully high on the AEMC's agenda and we look forward to contributing where we can through the various review and Rule change processes.

Having said that, we believe that the AEMC should have gone much further in its description and analysis of possible developments in the regulation and oversight of the distribution network. The sector accounts for almost half of the bundled retail and existing regulatory determinations will only increase the network share. We see major challenges ahead if there is to be any effective action to moderate the unprecedented increase in distribution charges and the consequent impact on retail prices.

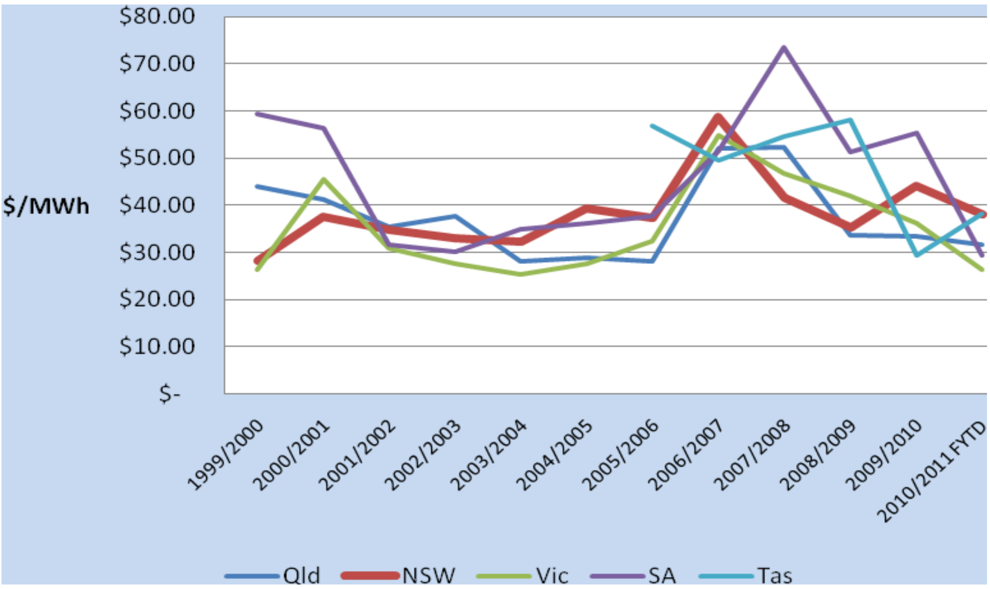
Wholesale electricity prices and distribution network charges

Macquarie Generation is concerned that policy makers and consumers will attribute sharp rises in retail prices to possible inefficiencies in the wholesale market. We have recently seen the Major Energy Users Group lodge a Rule change proposal with the AEMC which, if implemented, would fundamentally alter the operation of the NEM.

Anyone can follow dispatch and pricing in the NEM spot market in real time and market data is readily available from AEMO. What this data does not show is the role of financial products in managing wholesale price risks. Generators, retailers and other participants enter into hedging and other bilateral contracts to manage spot market volatility. Simplistic reporting of half-hourly spot price spikes fails to account for the role of the derivatives market. Any serious analysis of wholesale prices must also look at longer-term trends.

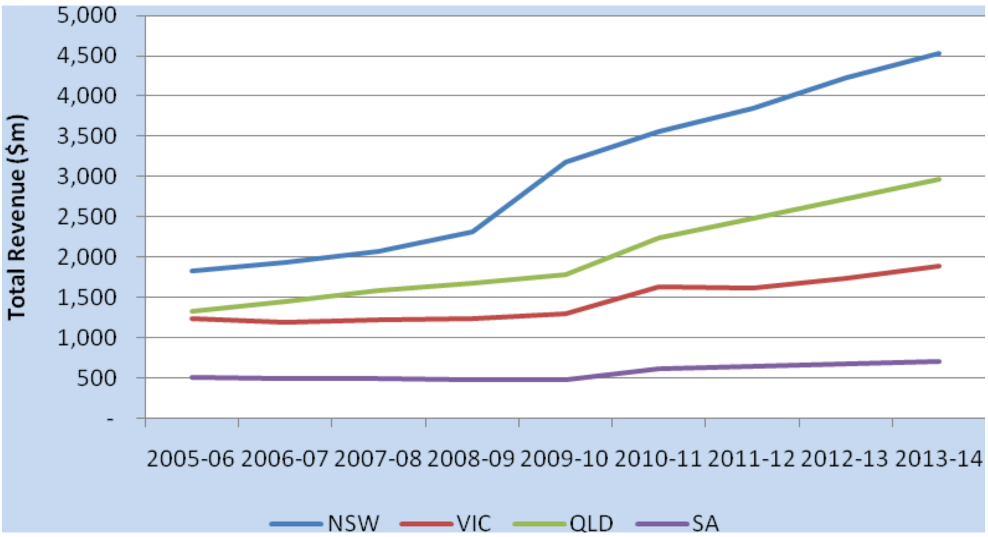
Wholesale electricity prices in recent years are roughly the same as they were at the start of the NEM. In the 2007 and 2008 prices rose sharply through a combination of severe drought conditions, major plant outages and record demand levels. Prices have fallen year on year since then. Current spot prices are will below the cost of new generation entry for all technology types.

Chart 1: Wholesale electricity prices, by region, ($/MWh, nominal)



IPART has recently published its draft report on changes in NSW regulated electricity retail prices from 1 July 2011. The price increases average about 17% for a typical NSW household. This follows an escalation of network charges and retail prices over the last five years. Similar increases have occurred in all other states. Further prices increases are built into the current AER five revenue determinations (see Chart 2).

Chart 2: AER distribution network annual regulated revenues, all distribution businesses within a region, ($ million, nominal)



Recent reviews of network charges

At the same time the AEMC published the draft Strategic Directions Paper, the AER released a public statement announcing that it is currently examining the Rules which it is required to apply when considering investment proposals from network businesses. Having completed a full round of determinations for all transmission and network businesses, the AER will now consider whether there is any way the regulatory framework can be improved. Given the increase in distribution network charges, we would be surprised if the AER does not find some areas for improvement.

As the AEMC would be well aware, IPART's recent draft report on retail tariffs recommended that the AEMC "initiate a review of National Electricity Rules to ensure the rules do not bias the Australian Energy Regulator's decisions in favour of higher network prices and inefficient outcomes". Macquarie Generation does not intend to go over IPART's report where it discusses a number of areas where there may be scope to improve electricity affordability. We agree with all of IPART's commentary and analysis about affordability, and we are sure that the AEMC has read the report closely.

The NSW Government commissioned the *NSW Electricity Network and Prices Inquiry* in 2010. The Inquiry Report details the movements in NSW retail prices and examines the main factors contributing to price rises. The Report provides a useful source of information and data on each sector of the NSW electricity industry. Much of the Report focuses on the drivers of network charges and possible trends and pressures in the next few years.

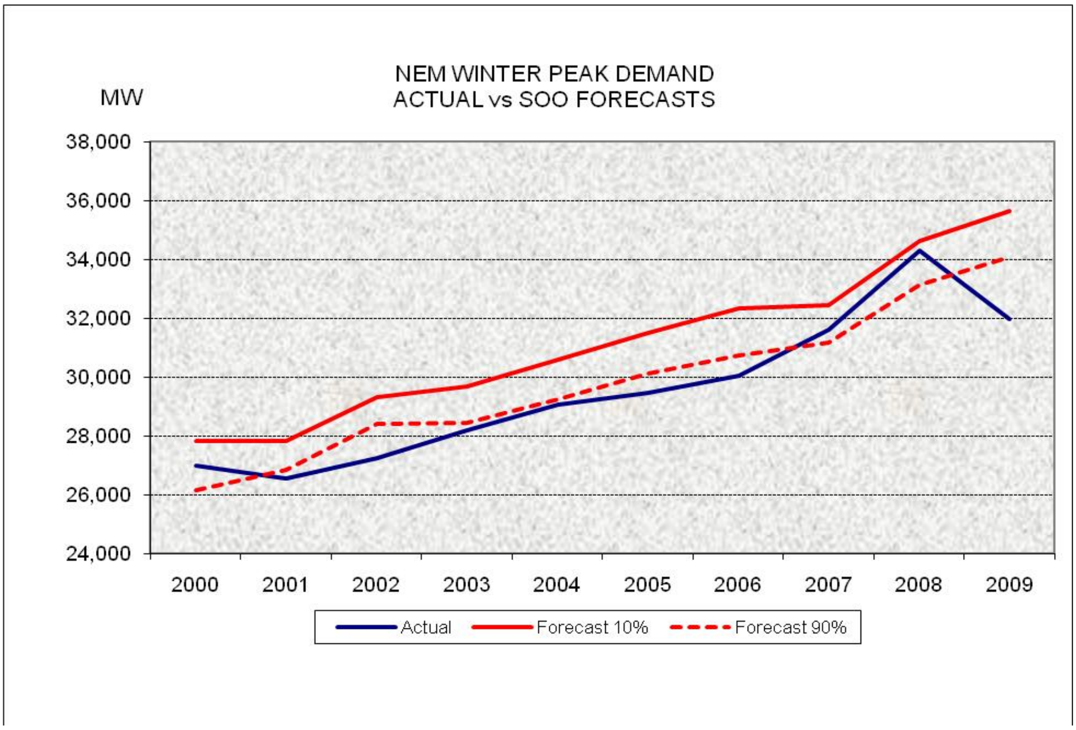
Load forecasting

Macquarie Generation has repeatedly expressed its concern with the poor load forecasting in all NEM regions. Peak system load forecasts are the most inaccurate but at the same time the most important.

Chart 3 shows a persistent over-forecasting of peak demands. The example given looks at the sum of all actual peak winter demands for all NEM regions over the past decade. The 10% and 90% probability of exceedance forecasts were taken from the AEMO statement of system opportunities report in the year immediately prior to the actual year. While this chart does not show regional differences, it does provide some indication of an underlying problem with the forecasting process.

Based on our experience, we believe there is an in-built regulatory bias to overstate peak demand forecasts which leads to over-investment by the transmission network service providers. No TNSP would want to under-invest in the transmission network if this later leads to supply interruptions. The same incentive framework may apply in the distribution network sector.

Chart 3: Sum of NEM region winter peak demand forecasts, actual versus forecast



Every five years the AER approves capital and operating expenditure allowances for TNSPs. TNSPs are entitled to earn a rate of return on the budgeted capital program. If a network business over-forecasts peak system demand and the business spends less than allowed, the TNSP benefits by retaining unspent revenues for the remainder of the 5-year period. The TNSP also earns a rate of return on the budgeted capital program even if it does not spend the capital expenditure allowance.

The revenue setting process is designed to ensure that customers do not pay for any unspent capital allowance from the previous regulatory period. At the start of a new 5-year period, the AER will only roll forward the actual capital expenditure from the previous period. The problem is that the TNSP may again forecast high peak demands for the following five years. There is little the AER can do to test the accuracy of these forecasts before it sets the next 5-year capital and operating allowance. Even with a reduced initial asset base, TNSPS may again benefit from an under-spend on capital programs if the AER approves a capital program based on inaccurate demand forecasts.

We believe the load forecasting process is an area where the AEMC could do valuable work. TNSPs and DNSPs are responsible for preparing load forecasts and we believe there should be better discipline in this area.

From a generation point of view, the practice of overstating demand creates a false perception of possible near-term capacity shortfalls in the generation sector. We are concerned that governments may change the market design or subsidise new generation investment that later proves unnecessary.

Strategic priorities

Rising electricity price rises have focused public attention on the electricity sector. Policy makers will look at all of the factors driving these increases. We expect the AEMC will be obliged to review the distribution network regulatory framework as part of this process, possibly within the next year. The AEMC should be able to draw on the work carried out in various review processes that are underway or already complete. At the same the AEMC should be allocating resources to this area as soon as practicable and documenting in its Strategic Directions Paper how it intends to prepare for and undertake this work.

Yours sincerely

TIM ALLEN
MANAGER, MARKETING & TRADING