Delta electricity

13 May 2011

Mr John Pierce
Chairman
AEMC
Level 5, 201 Elizabeth Street
SYDNEY NSW 2000

Dear John,

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

Delta Electricity (Delta) supports the submission by the Electricity Supply Association of Australia on the AEMC's Strategic Priorities for Energy Market Development discussion paper and welcomes the opportunity to provide additional comments.

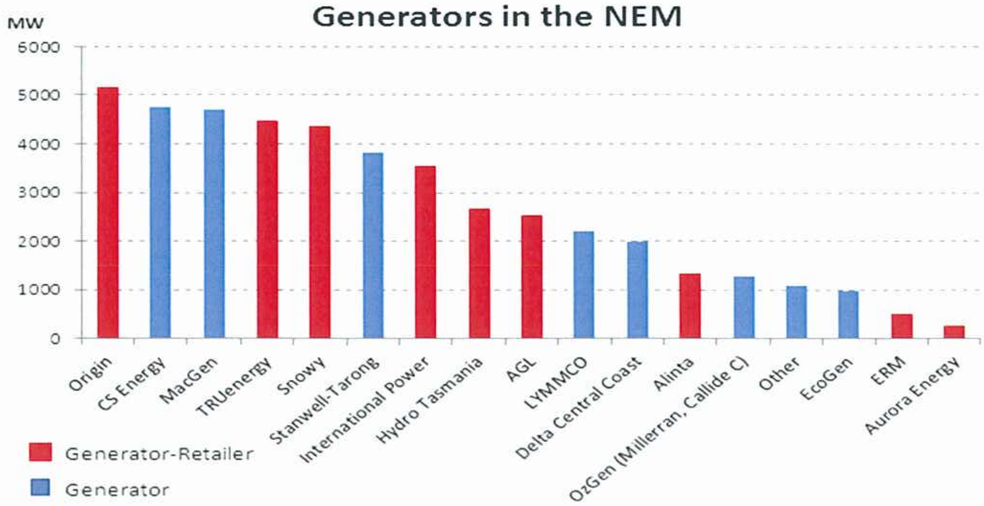
The Australian electricity and gas markets are facing unprecedented challenges arising from evolving industry structure (generator-retail businesses), carbon policies and rising costs. In the face of these challenges, the interests of market participants and consumers are best served if the energy markets operate efficiently and promote timely investment in new generation and network capacity.

The AEMC work programs associated with the three strategic priorities identified in the paper relate to important, but discrete, activities which are largely already underway. Delta believes that the electricity and gas markets should be reviewed against future needs with consideration given to whether fundamental changes to market design are required.

NEM Design and Operation

The most prominent trend in the energy industry of recent times is the integration of electricity generation and retail. The following chart shows the relative size of generators in the NEM and those businesses that also perform retail functions.

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT



The gross pool model, supported by a well-developed derivative market, delivers efficient price outcomes when there is strong competition between generators in the wholesale market and strong competition between retailers for end-use customer load. Retailers, in particular, have invested in generation assets to best manage their wholesale price and volume risks. It is anticipated that the trend of integration will continue, with diminishing volumes transacted through the wholesale futures and OTC market. It is unclear whether the current market design will continue to deliver the best outcomes for end-use customers.

The energy only design of the market (i.e. no payments for capacity) builds in over supply to cover the forecast 10% POE peak demand plus a reserve margin. This over supply suppresses average spot price outcomes and can be an impediment to investment in new baseload generating plant. The impact of small distributed energy sources and the likely greater role for DSM may further test the sustainability of the current market design.

Delta recommends the work scope of strategic priority one be expanded to include a review of the NEM's ability to deliver economically efficient investment in a future where most participants are vertically integrated. Consideration of overseas market developments, such as in the UK, may provide useful insights.

Rising prices

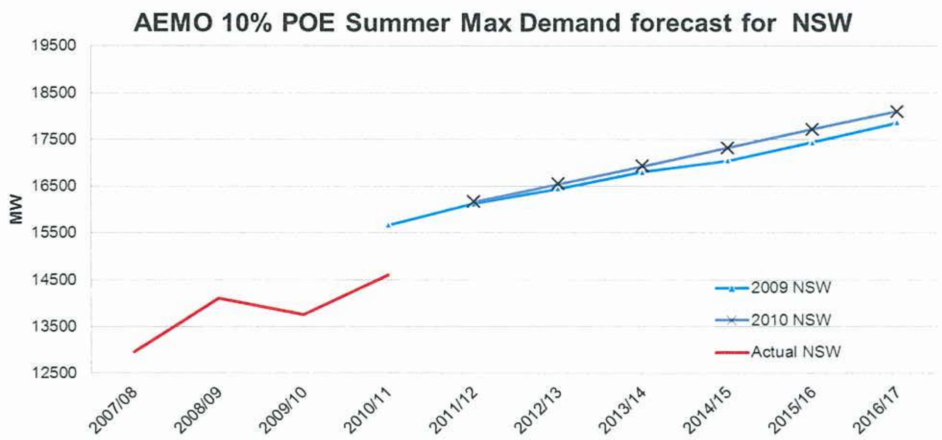
IPART's draft determination for regulated electricity prices in NSW, published in April 2011, proposes substantial increases in prices over the next three years. This is due largely to green scheme compliance costs and network charges. These forecast price increases do not include a carbon tax. To ensure electricity price rises are minimised, it is imperative that generation, network, and energy efficiency investment decisions are economically efficient. That is, different technologies need to be treated equally, with appropriate locational network pricing signals in place. The AEMC's review of the investment environment must also give consideration to ensuring capital utilisation is optimised and that the setting of feed-in tariffs does not deliver a competitive advantage to distributed energy sources over more traditional generation technologies.

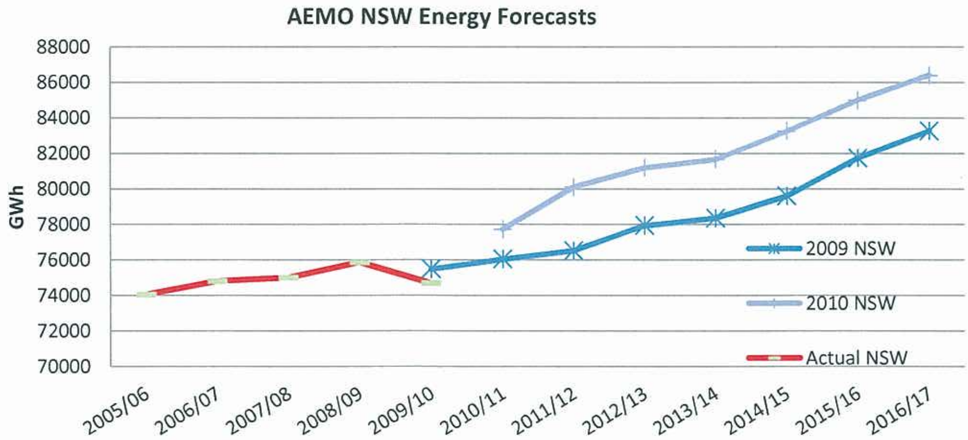
STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

Demand and Energy Projections

Carbon related policies are likely to drive substantial new investment in gas generation and networks this decade. The timing of investment is guided by supply shortfall projections such as those published by AEMO in its Electricity Statement of Opportunities (ESOO). In recent times market projections have tended to over forecast demand and energy growth, which in turn has overstated the need for new generation and influenced assessments of network capacity and interconnector upgrades.

The response to climate change policies has delivered improvements in energy efficiency at the consumer end of the market and driven significant investment in distributed solar photovoltaic systems. This has reduced growth in NEM peak demand, and in NSW led to negative energy growth. The following charts compare recent actual peak demands and electricity consumption with AEMO forecasts.





Sydney experienced one of its hottest weeks on record in early February 2011 whilst other parts of NSW experienced extreme temperatures. The peak NSW demand for electricity in this week was an all-time record but still well below the forecast 10% POE level of recent forecasts. Peak demand forecasts, used by network owners and generators for investment planning, have not proved to be a good guide. Similarly, the recent NSW energy forecasts still indicate solid load growth even though recent history shows energy efficiency measures and solar PV has largely offset underlying growth from new customers.

The work scope under strategic priority two should be expanded to include an assessment of the provisions of energy and demand forecasts in the NEM and how these forecasts influence investment decisions.

Gas Market Development

The paper's prime focus is on electricity markets, however, an increase in the demand for gas arising from climate change policies and LNG exports from Queensland will place considerable pressure on gas prices in the near future. The establishment of the STTM should deliver increased competition and improve pricing transparency. However, substantial further development of the gas markets is required if they are to deliver the same level of competition as the NEM.

Delta recommends a review of the gas markets covering:

- Responsibility for gas system security

  Gas supply security largely remains with the pipeline operators in NSW. When gas supply issues arise there is no independent oversight of system security to manage limited supplies within the state and from VIC and SA to NSW.

- The ability for large consumers to opt out of the STTM

  The STTM rules allow large consumers, such as gas fired generating plant, to opt out of the spot market. Thus the STTM has some characteristics of a 'net pool' spot market. It is unclear how the STTM design will facilitate new entrant gas supply and support efficient investment in new merchant electricity generation plant.

- Inclusion of gas producers in the STTM

  Gas producers are not bound by the STTM. As such, there is no ability for the market operator to direct gas producers at times of supply shortages or system events. A major risk to electricity supply can occur at times of gas supply limitations.

- STTM Rules

  Unlike the NEM, the STTM has no provisions to allow for the timely rectification of manifestly incorrect spot prices. Market participants unduly face significant price risk that will arise from time to time when simple data errors are made.

STRATEGIC PRIORITIES FOR ENERGY MARKET DEVELOPMENT

- Prudential requirements

  Opportunities exist to reduce the financial burden on gas consumers from the prudential obligations under the STTM. Consideration should be given to allowing gas and electricity market participants to net off their prudential requirements to AEMO across the two markets.

- Provision of gas supply problems from outside the jurisdiction of the STTM

  At this time there is no provision for details of major gas supply incidents in VIC or SA to be given to NSW STTM participants, even though such incidents may have a significant impact upon gas supplies. Large consumers, in particular, would be better placed to manage supply risks with increased transparency of information across all jurisdictions.

Delta strongly recommends the inclusion of a separate strategic priority for gas that includes a comprehensive assessment of the eastern Australia gas markets and the interaction with the NEM.

If you require additional information from Delta on the matters raised, please do not hesitate to contract Mr Tony Callan, General Manager/Marketing, on (02) 9285 2712.

Yours faithfully,

GREG EVERETT
CHIEF EXECUTIVE