

Our Ref: OCEO-75868

13 May 2011

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

Dear John,

Strategic Priorities for Energy Market Development

Hydro Tasmania congratulates AEMC on this initiative to focus reviews on the key areas of market development. In this submission, we make some general observations relevant to the environment and then present our views on specific priorities.

1. Some Initial Observations

1.1. Market Design

Our comments are made against a backdrop of our view of the current market design. In our view, the current NEM market design has proved itself robust to date, providing competitively priced electricity, a high standard of supply reliability and significant new investment. It is, however, on the cusp of a new carbon era.

The introduction of the carbon price will clearly be a challenge to the market but we would put it in the following perspective. If you skip forward around twenty years with a material carbon price and where the LRET price has dwindled significantly, there would be no reason to expect any problem from the current market design. The carbon price changes the merit order of plant but there is no reason to expect a need for any re-design.

A smooth transition is the key. The design of the carbon price is critical, together with its introduction to provide certainty for both investment and market operation.

1.2 Number of Reviews

We are generally concerned at the very high number of reviews, many of them overlapping, which are currently underway. Whilst it is clearly useful to have some market reviews, the current level of activity is disproportionate to the level of problems in the NEM and also inefficient. Some of the issues from this excessive activity are:

- Significant costs are incurred by the businesses in responding to these reviews both directly and through industry associations

- Reviewing bodies are overloaded with insufficient resources to provide quality results or routine work is delayed
- The reviews engender investment uncertainty as investors can never be sure of the outcome of the review

We believe that the creation of a list of strategic priorities will help focus the MCE's requests to the AEMC to areas of greatest return.

1.3 Long Term Impact of Aggregation

The NEM has been characterised by increasing aggregation as businesses seek to manage their risks through horizontal and vertical aggregation. This trend has accelerated as the NSW and some Queensland businesses have been sold.

The NEM is a framework which depends on effective competition to achieve the efficiencies which it is designed to achieve. This level of competition can only be maintained with sufficient separate businesses and/or low barriers to entry for new entrants.

The policy safeguard is the CCA which stops mergers and acquisitions where there is a "significant lessening of competition". The question for the electricity market is "Will the CCA be effective at preserving competition?".

The Government has already adopted a "four pillars" approach in the banking industry for similar reasons. We believe there is a body of work required to assess whether there is a medium term problem and, if so, what solutions might address it.

We note that this issue is a part of the AEMC's proposed Priority One.

2 AEMC Proposed Strategic Objectives

The AEMC has identified three Strategic Priorities. Firstly, Hydro Tasmania supports the concept of having a very limited number of priorities for the reasons mentioned above. It is also important to recognise that the AEMC has more chance of influencing outcomes in some areas than others. It is not desirable for AEMC to undertake work in areas where there is very little chance of changing outcomes.

2.1 Priority One

The first priority identified is:

- A predictable regulatory and market environment for rewarding economically efficient investment

Hydro Tasmania supports this priority but would like to see it recognise some additional issues. The paper quotes three primary sources of uncertainty and we amplify our views against each of these.

2.1.1 Government policy settings

The uncertainty generated by Government's inability to provide a clear policy direction is well documented. It is, however, often not appreciated that the industry's emissions are actually higher than with a business as usual scenario in

which carbon had never been discussed. This has come about as a result of delays in routine investment in plant efficiency which would have happened in the absence of a carbon debate. So delay has actually made us worse off than a no carbon scenario.

Secondly, as a result of the NEM behaving robustly, there is a mistaken belief that government intervention (both federal and state) can not destroy the market. This has already happened in other jurisdictions overseas and needs to be seen as a real risk for Australia. This risk extends to the government introducing policies which are inconsistent with a market. A carbon tax and an emissions trading system are both market compatible in principle but the specific danger in this area is the policies which are introduced to support the transition to low carbon generation.

AEMC's policy advice to government needs to be cognisant of both these areas.

2.1.2 Impact on contract market with changed market structure especially vertical integration

This aspect is really a subset of the issue of aggregation which is discussed in section 1.3. Consequently, we propose that this part of Priority One should be expanded to have this broader scope. The AEMC should undertake work to establish whether there is a need for some complementary policy to the CCA, such as exists in the banking industry.

2.1.3 Finance shortage since GFC

Investment certainty is the key driver, not a finance shortage. The principal drivers of this uncertainty are now market signals and the carbon price uncertainty.

2.2 Priority Two

The second priority identified is:

- Building the capability and capturing the value of flexible load

This priority appears to be a given as the MCE has just issued a Terms of Reference for AEMC to undertake the third review into this topic. There are clearly both energy and network benefits in removing the needle peaks but there has been very little success in making any progress in this area as a result of the first two reviews.

With market maturity, there appears to be more interest from customers in responding to high priced events. They do this by putting their discretionary load on the spot price and then responding to high price events by reducing their load. This can be very lucrative for them and it also provides a public benefit. This response is exactly the kind that a market should encourage.

2.3 Priority Three

The third priority is:

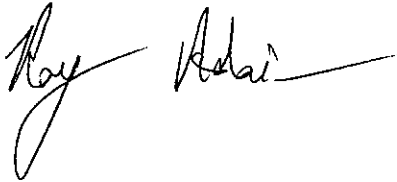
- Ensuring the transmission framework delivers efficient and timely investment

This is the subject of a major review that is already underway and consequently it has to be a strategic priority. It is important that this review addresses the issues of cost effectiveness and value for money.

Finally, transmission should be made the second priority as it is a much more significant issue than demand side in achieving an efficient electricity market. This would make demand side the third priority.

If you have any queries, please contact David Bowker on 0418 136 493.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Roy Adair', with a long horizontal flourish extending to the right.

Roy Adair
Chief Executive Officer