25 February 2009

Dr John Tamblyn
Chairman, AEMC
By email: submissions@aemc.gov.au

Dear Dr Tamblyn

AEMC Market Framework Review

I write on behalf of the above listed generators in response to the AEMC Review of Energy Market Frameworks in light of Climate Change Policies, 1st Interim Report, dated 23 December 2008.

Please find enclosed a submission in response to part A8 of the aforementioned report. This submission should be read in conjunction with our submission in response to parts A1 to A7.

Please direct your response or any questions regarding this submission to the undersigned on (03) 9612 2236

Yours faithfully,

Jamie Lowe
Manager, Regulation
Loy Yang Marketing Management Company Pty Ltd
Level 27, 459 Collins Street, Melbourne, Victoria 3000

On behalf of:

Alex Cruickshank Manager, Wholesale Markets Regulation AGL Energy Limited	**David Hoch** Regulatory Policy Manger International Power
Mark Frewin Regulatory Manager TRUenergy Pty. Ltd.	**Roger Oakley** Manager, Market Development LYMMCo


AGL
International Power
TRU
energy
LOY YANG
Marketing Management Company

AGL Energy

International Power Australia

Loy Yang Marketing

TRUenergy

Submission in response to the:

AEMC

Review of Energy Markets in light of Climate Change Policies,

1st Interim Report of 23 December 2008

Part A8

February 2009

Executive Summary

AGL Energy Limited, International Power Australia, Loy Yang Marketing Management Company Limited and TRUenergy Propriety Limited make this joint submission reflecting their common views regarding the risks to market sustainability and long-term provision of reliability under the current NEM arrangements and our common interest in the efficient operation and sustainability of a competitive electricity market.

We make the key points regarding financing of new investment below in our submission.

Financing new investment

- The NEM investment environment can be adequate provided it operates within a stable policy environment, offers internationally competitive returns to investors, and is supported by a well functioning contracts market.

- Challenges remain on each of these fronts, and so it is critical the AEMC takes every opportunity to enhance the attractiveness of the NEM as a generation investment destination, if ongoing reliability and security are to be delivered.

This submission should be read in conjunction with our submission in response to parts A1-A7.

Introduction

AGL Energy Limited, International Power Australia, Loy Yang Marketing Management Company Limited and TRUenergy Propriety Limited represent the largest collection of private investment in electricity generation in Australia.

AGL Energy Limited is Australia's largest integrated energy company with a full suite of renewable generation, providing natural gas and electricity to more than six million Australians and with major investments in the supply of gas and electricity, as well as a substantial base of customers across Australia. Listed on the Australian Securities Exchange, AGL has a market capitalisation of about A$5.2 billion. The company has been operating in Australia for 170 years and was one of its first listed companies.

International Power Australia is Australia's largest private producer of electricity, producing 24 TWh in 2008 or about 11 per cent of all electricity in the NEM. It has a portfolio of around 3,200MW (equity owned) of diverse fuel and technology generating capacity across Victoria, South Australia and Western Australia including 1,177MW of wind farms. This portfolio is complemented by the IPRA-owned Simply Energy, an electricity and gas retail business which currently represents around 7-10 per cent of the Victorian and South Australian retail markets.

Loy Yang Marketing Management Company trades the largest privately-owned generator in the NEM. In total, Loy Yang Marketing Management Company trades in excess of 2,200 MW and represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia.

TRUenergy Propriety Limited supplies gas and electricity to homes in Victoria, South Australia and New South Wales and generates electricity in both Victoria and South Australia. TRUenergy manages a diverse energy portfolio covering $5 billion of assets that includes electricity generation, energy contracts management and trading, gas storage and retail energy services employing over 1000 people.

The outcomes of the AEMC Review of Energy Market Frameworks in light of Climate Change Policies are directly relevant to sustainability of ongoing investments in this market, and the regulatory and sovereign risks that face investors.

These businesses have prepared this joint submission to the as they share a common interest and common concerns in the sustainability of the NEM market.

Issues A8: Financing new energy investment

AEMC position

The AEMC provides that existing frameworks will facilitate the financing of the additional investment required to support the generation and network sectors in light of the introduction of the CPRS and RET.

Discussion

The question of whether existing market frameworks can deliver the required investment depends on the following conditions being met:

- stable and predictable policy environment;
- availability of finance and competitive returns compared to other global investment opportunities; and
- a well functioning contracts market to underpin long-term revenue certainty for generation investors.

If these conditions are not met, the AEMC's belief that the existing market frameworks will facilitate the efficient financing of additional investment is not supported. Moreover, in the context of the Global Financial Crisis, the risk appetite of equity and debt holders has reduced undermining existing incentives to invest in the Australian energy market. In that regard, the importance of the above conditions is heightened in the current climate.

Level of Regulatory Risk

Sovereign risk is an ongoing concern for investors. With the CPRS and the expanded RET, the Government has introduced a high level of regulatory and sovereign risk at the expense of existing asset holders (equity and debt). Specifically, the level of assistance provided under ESAS is inadequate to maintain balance sheet values. Modelling undertaken by the industry and by the Commonwealth Department of Treasury supports this view.

As such, sovereign risk concerns have been realised and in this context, financial markets are likely to take a highly cautionary approach to investment in merchant generation into the future. This may include the requirement for strong securities to support possible investments and committed pass-through provisions for any climate change policy related costs.

Impact of Renewable Energy Target

It is possible that in the steady-state, that CPRS can be managed by the market provided it is applied uniformly; however, there are growing questions about the current market design's adequacy to manage the economic distortion created by the RET, particularly since it creates uneconomic incentives, and attracts generation that by its very nature is likely to be intermittent and therefore requiring back-up capacity.

Since the implementation of the energy-only market, the markets ability to deliver revenue adequacy for peaking plant has been repeatedly debated. We note that

these concerns were raised prior to the RET, and are compounded by the increased need for peaking plant or "spinning reserve" FCAS capability to contend with intermittent generation.

In addition, we note that the intent of the CPRS is to progressively reduce commitment of coal fired generators (which have been a significant traditional source of capacity). This may exacerbate the existing requirement for back up capacity, and hence increase pressure on the energy-only market design (particularly if reforms to in the area of inertia compensation are not pursued).

In this context, further investigation of the market design issues raised in the report to the AEMC prepared by MMA, entitled 'An initial survey of market issues arising from the Carbon Pollution Reduction Scheme and Renewable Energy Target', may be warranted.

Short-Medium term transition issues

The AEMC suggests that the ESAS may alleviate NEM reliability concerns arising from the potential financial distress of high emissions generators. However, in our view these concerns remain unresolved as the ESAS package is not sufficient to deliver a smooth transition for companies that are heavily invested in high emission generators.

Given the impact of the proposed package on existing equity (and potentially debt) holders, it is questionable whether financing will be available to support the transition. It is already evident that the potential financial distress to existing assets created by the CPRS is bringing into question several billion dollars' worth of refinancing for generators (the S3 report commissioned by the AEMC refers to this).

Thus, even if the financing community is supportive of new low carbon investment, we believe it is already questioning its support of the generation stock that will be required to maintain security and reliability of supply until new low-carbon emission plant is implemented. The Government modelling of the transition to a low-carbon energy future, clearly relies on a substantial stock of existing coal-fired generation remaining in place for an extended period.

Energy-only markets rely on energy prices to reach levels sufficient to make a contribution to fixed costs and to achieve revenue adequacy. Unless the market has the right balance of base, intermediate and peaking plant, and is free from intervention, achieving revenue adequacy is problematic. As noted, refinancing of existing plant is extremely difficult as a result of reduced supply of capital and greater risk aversion by lenders, exacerbated by the additional uncertainty and risks discussed above.

Need for a well functioning contract market

It is important to acknowledge the critical role that the contracts market plays in underpinning the NEM investment environment. Without the ability to manage market risk that the contracts market delivers, financing generation investments will become increasing difficult.

Reduced liquidity in the contract market for the period's post the mooted CPRS start date has been widely reported.

Contract liquidity beyond June 2010 is currently crippled by the reluctance to sell by generators unable to manage the CO2 price risk and permit availability. Annual permit costs will far outweigh, by a factor of several times, that of fuel costs for brown and black coal generators. As yet, sourcing and costing of permits remains unclear. Government modelling has shown large reliance on lower cost permits being imported to meet Australia's emission caps.

Deep and liquid markets, both physical and secondary, are required to manage such risk, yet these markets are non-existent due to lack of clarity beyond the 2012 Kyoto commitments and regulatory arrangements.

Summary

There may be little the AEMC can do directly to resolve these issues; however, we believe that an understanding of the environment in which the NER provisions operate is necessary to enable the AEMC to weight the importance of various NEM design decisions.

The increased market revenue risk as a result of the outlined policy changes is large and to a large extent unmanageable. Therefore, the AEMC is urged to adopt a holistic view of the challenges facing the energy-only market, which may lead to market failure in the absence of careful consideration of the design of the current energy-only market.

It is important for the AEMC to appreciate the overall investment environment in which the NEM operates to allow judgements on the weightings of NEM design decisions to be made. In particular, we note that questions remain regarding the adequacy of ESAS, the ability of high emission plants to refinance in the near term, and the affect of the carbon market on the contracts market.

Problems in these areas are likely to impact on reliability outcomes in the NEM. In this environment, it is important that the NEM design is biased to create a positive environment for infrastructure investments so that the risk reward pay-off is sufficient to attract capital in the face of these wider uncertainties.

Some key areas were the energy market frameworks can be enhanced to create the required investment environment include:

- ability of investors to manage congestion risk;
- removal of retail price regulation;
- expansion of market based ancillary service arrangements; and
- improved Victorian gas transmission regime.

Resolution of these and other matters, canvassed in our submission in response to A1 to A7, will assist to promote the desired investment environment.