7 January 2013

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

Dear Mr Pierce

CME Report: Electricity market power in South Australia

I write to outline Alinta Energy's perspectives on the content of the Carbon + Energy Markets (CME) report entitled *Electricity market power in South Australia* (the CME Report) part funded by the Consumer Advocacy Panel.

Alinta Energy believes the CME Report is yet another example of segmented analysis where a particular interest is pursued at the expense of illustrating the genuinely efficient outcomes achieved across the National Energy Market.

The issue for consideration is not can generators withhold supply at points in time or do prices near the Market Price Cap raise yearly average prices, but is the market competitive so that it minimises total delivered costs of energy to consumers, are price risks appropriately allocated, and can participants manage these risks through available products.

The answer to the latter questions are clearly yes, yet the obsession with economic withholding and point in time productive efficiencies remain; possibly as it is easier to illustrate and grapple with these short-term outcomes than appreciate the benefits to consumers of long-run efficiency.

Alinta Energy has previously argued against the sense some stakeholders have that the market can or should distinguish between "artificial scarcity" and "real scarcity" or an "ideal" number of high priced events. The argument presupposes that the actions of the individual firm, impacting on spot price outcomes, are inefficient on specific occasions, while not accounting for the difference between long-run and short-run effects.

In Alinta Energy's view, the issue is not whether economic withholding exists and whether that "gaming" from time to time may influence price outcomes, in particular by exacerbating reactions to exogenous factors, but whether such withholding illustrates systemic inefficiency. Alinta Energy holds the view that the National Electricity Market functions in an efficient manner consistent with the AEMC's perspectives on workable competition.

As part of their operations, firms bidding into the National Electricity Market and contracting must respond to not only underlying supply and demand but exogenous shocks. These primarily take the form of weather events and the corresponding step changes in demand or transmission outages. Concern around rebidding and economic withholding seems to be that bids reflect not a response to underlying market conditions and exogenous events but strategic gaming as if these factors can be readily identified and separated.

Alinta Energy is certain that bidding around demand shocks and similar factors ultimately lead to the efficient management of those factors. In other words, outcomes across a period affected by an exogenous factor (i.e. a hot afternoon or series of days) manage consumption and supply efficiently in the context of the markets design (i.e. by making supply available to meet demand under the prevailing market conditions).

For economic withholding to have relevance within the existing debate a generators ability to game could only arise if its response to an exogenous shock, primarily a demand shock, did not give rise to any counter bids or actions outside the spot market (i.e. buy buying contracts, selling caps, curtailing load or selling demand-side response) which mute the impact of that gaming for the duration of that shock, for future events or over the long-run.

Furthermore, over the longer term, sufficient barriers to entry would need to exist to impede a competitor entering the market to respond to exogenous factors and general price spikes which form valid market signals or a consumer would need to be prevented from responding where they are directly exposed to those price events. In other words, unless a generator can hold the market to ransom for an extended period than transitory market power is of limited consequence in the long run.

Perspectives on the CME Report analysis

Alinta Energy does not support the conclusions of the CME Report and notes a number of issues with the analysis.

The assertion that market power is a measure of unused capacity is novel but is unlikely to be a valid measure of market power. The paper is thus an entirely conceptual piece that while interesting, can only infer issues based on the premises of CME and does not provide any authoritative conclusions on market outcomes or the issue of market power. Alinta Energy contends the work undertaken by the AEMC is more useful in this context.

It is unclear how CME has derived its data on capacity given there is often a noted difference between nameplate capacity, available capacity and used capacity with each subject to change due to re-registration, maintenance, fuel supply and otherwise.

For instance, high temperatures are instances when plant like Alinta Energy's Northern Power Stations are most at risk of trips (when demand and temperatures are in the mid-30s in South Australia they are often in the mid-to-high 40's in Port Augusta where staff are physically working at the power plant). This creates an incentive for economic (don't want to trip plant and lose future revenues and be exposed to high prices) and safety reasons (hot plant can't be easily repaired) not to push the plant to maximum capacity.

The CME Report fails to reflect the actuality that generators seek to maximise the value of trade to cover short-run and long-run costs and do this through both spot and contract market exposure, and additionally in the context of evolving outcomes for fuel in the gas and other markets.

The CME Report is one-sided in its analysis and fails to note the impact of negative price events of which there have been around 500 since 1 January 2006, the impact of an absence of transmission rights which reduces the incentives to contract, power system reliability and its impact on contracting for large plant, the role generators play in pushing down prices to match contract positions (i.e. high price incentives are matched by low price incentives depending on individual generator contract positions), the impact of drought, and the decisions of some major users.

The CME Report is also hampered by its ability to understand the use of settlement residues to manage spot risk by market participants in South Australia, and the use of forward contracts in other

regions, in particular Victoria which is closely aligned with South Australia, in place of South Australian forwards.

Likewise, the use of weather insurances and other instruments by both load and generation present other ways to manage spot market risk that cannot be captured in the CME analysis.

The CME Report does not address the role of high prices in recovering large capacity costs or in providing signals of market entry to generators and retailers.

- High spot market and/or contract market prices provide an incentive for additional generation build or additional contract offerings by generators both in the South Australian region or from other regions as well as financial intermediaries.
- High retail prices provide a driver for additional retail entry to take profits from incumbent retailers should enough headroom be available to allow for competition.

The CME Report also infers that prices were at appropriate levels before the 0.4% of the time when "extreme prices" were recorded and that prices are again appropriate in 2012 as they are lower; however, Alinta Energy contends that prices in South Australia in both the spot and contract markets have been insufficient on many occasions over a sustained period and Alinta Energy's recent shut-down of the entire Augusta Power Stations facility (Northern 1 and 2, and Playford B) is more indicative of market outcomes than the propositions in the CME Report relating to 72 specific settlement periods.

This relates to the concept of spare capacity also. Playford B Power Station is currently not available for generation but can be brought back to service within a defined timeframe should the market evolve accordingly or low reserve conditions eventuate. However, this requires a change in prices greater than a 30-minute settlement period at the Market Price Cap as the costs of having a plant in service are significant.

This suggests, as does most of the report, that average prices undervalue the costs of maintaining a generator or generation portfolio. This is consistent with the financial outcomes of many generators over the history of the National Electricity Market

The CME Report also fails to note that given the lumpy nature of generation investment that the market is always likely to be characterised by a oversupply or an undersupply of generation assets at any point in time which means the market may operate above or below long-run marginal costs for an extended period and that would be efficient (in the absence of external interventions, not because of such interventions). This would not be the case if generation assets were perfectly divisible.

Hence, it is probable that in the absence of exogenous factors that drive prices higher than underlying demand either at a point in time or generally, the current overhang in supply may continue to suppress prices in the near term.

The CME Report is balanced on a number of assertions and hypotheticals and is couched in unproductive language. The characterisation of prices approaching the Market Price Cap as extreme is emotive at best. The Market Price Cap is a known to all participants including load that choses not to contract and is a credible market outcome especially during hot high demand days in South Australia. Likewise, conclusions on individual generators profitability need to be assessed in the context of the entire life of that asset and within the context of the portfolio of assets.

The CME Report notes large percentage increases in average prices as some sort of evidence that high priced settlement periods are problematic, as if this is not part of the markets' design. Ironically,

the CME Report then proposes capacity payments as one possible solution to high priced events without noting that these high priced events would need to be factored into capacity charges. Alinta Energy's experience in capacity markets suggest that they introduce an additional range of complications that the National Electricity Market has done well to avoid.

The CME Report concludes that contract prices can predict spot prices. This is a mischaracterisation in Alinta Energy's view. The contract market provides an appropriate mechanism for managing spot market risk given that the contract market forward curve is the best interpretation of the markets view on spot price outcomes; however, it is also affected by its own dynamics.

Nevertheless, the CME Report fails to note that for this reason it would be foolish for large load or generators to completely expose themselves to spot as benign price outcomes will not be sustained and volatility is an efficient feature of the market design.

The CME Report inadvertently illustrates that there are multiple drivers for new supply in the market and that the market has effectively delivered new supply as generation continues to grow in excess of demand and hence there is a surplus of supply over demand in both average and peak that has resulted in declining average prices and limits the exercise of (transitory) market power in any case.

Alinta Energy notes that market price signals are but one incentive to increase generation supply another is the management of a retail book. Interestingly, a lower price cap could arguably reduce the incentive to increase supply especially for gas fired turbines that recover cost through peak prices and sale of market caps. Any discussion around the Market Price Cap should be considering why generation investment is valued below transmission investment as the Market Price Cap is significantly below the Value of Customer Reliability but privately funded generation is a substitute for transmission in many instances.

The CME Report demonstrates that there are no enduring instances of market power in the National Electricity Market –

- recent price outcomes do not reflect the contested concerns expressed in the CME Report for the 2008 to 2011 period;
- the apparent exercise of market power was not consistent with a pattern of behaviour by one generator but by different generators at differing points of time; and
- excluding instances of high priced events, which are very rare according the CME Report at 0.4% of the year, average prices are similar across regions that have similar generation profiles i.e. Tasmania was the sole outlier.

Nevertheless, the sometimes popular constraint on vertical integration is cited as a possible remedy. Alinta Energy notes that its entry into the South Australian and Victoria retail markets is on the back of its South Australian generation assets. Vertical integration is not a problem where there exists a number of competitors who are competing for market share.

CME Report in context

The CME report deals with many of the issues raised during the assessment of the National Electricity Amendment (Generator Market Power in the NEM) Rule 2011 proposal generated by the Major Energy Users. Unfortunately, the CME Report fails to draw upon much of that analysis including the AEMC conclusions that:

> *Based on the AEMC's analysis, consultant analysis and stakeholder feedback to the consultation paper, directions paper, public forum and technical paper, there is insufficient*

evidence of the existence of substantial market power to warrant the introduction of a rule that restricts the dispatch offers of generators in the NEM.[1]

Nevertheless, and despite the CME Report indicating that it considers the 2008 to 2011 timeframe to be remarkable, the desire to regulate into the future remains and the CME Report presents a host of options for "reform" that in many respects are fundamentally at odds with its own analysis.

Alinta Energy is disappointed by the CME Report especially given its timing outside of the Major Energy Users rule change proposal assessment process and does not believe the analysis or conclusions are particularly constructive.

The CME Report analyses the issue of market prices underpinned by a view that high prices are inefficient and inappropriate in the National Electricity Market. This view mirrors the claims made by members of industry who with hindsight mistakenly made the decision to take on spot market exposure, in a volatile market, in a region of the world that has the hottest and driest summers. This is compounded by the fact some of these users are manufacturers and that the South Australian generation mix includes a large proportion of subsidised wind generation which is of little assistance on very hot, very dry days when the wind tends not to blow.

Nevertheless, these very same users have no market power concerns when prices are low and the CME Report makes little reference to the multitude of negative price events that occur in South Australia on an ongoing basis where generators effectively pay for the privilege of generation. However, transparency around the contracting decisions of these participants is something that has not been raised in the debate to date but would arguably be telling.

Further, the CME Report, as has been the case with similar claims, does not consider the damage to the market of ongoing prices below long-run marginal cost and the failure to signal a need for new entry that flows from low prices. Interestingly, recent action by the Public Utilities Commission of Texas is in response to the issues that can arise when generators are not able to recover their long run costs.

If the CME Report is correct, in that contract markets reflect the level of risk in the spot price (but is it not accurate to say they predict spot price outcomes), then participants on the supply and demand sides are right to use contractual markets (and similar mechanisms) to manage spot market volatility. Not to do so exposes unhedged participants to a large risk premium if prices are significantly above (for load) or below (for generation) the average. Of course an alternative for load, should major users be convinced that costs are in excess of long run averages, is to engineer and construct power stations of their own.

Yours sincerely

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[1] AEMC, Draft Rule Determination, Potential Generator Market Power in the NEM, p.i