AUSTRALIAN ENERGY REGULATOR

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

John

Dear Dr ~~Tamblyn~~

AEMC review of the effectiveness of South Australian retail markets

I refer to the AEMC's current review of the effectiveness of retail competition in South Australia and in particular recent discussions with AER staff concerning the high priced events that occurred in South Australia earlier this year.

South Australian high priced events

As you would be aware, prices in South Australia averaged $243/MWh in the March quarter 2008, a record for the National Electricity Market (NEM). A number of factors contributed to South Australia's record prices. Adelaide experienced an unprecedented 15 day heat wave in March 2008, which led to record demand. In December 2007, the South Australian transmission network owner, ElectraNet, reduced the maximum allowable flows on the Heywood interconnector by about 25 per cent, restricting electricity flows from Victoria at these peak times.

Against a backdrop of high demand and tight supply AGL Energy, which owns 39 per cent of South Australia's generation capacity, bid a significant proportion of its capacity at close to the price cap. In combination, these factors led to sustained high prices in South Australia over 15 consecutive days in March 2008 and, for the first time in the history of the NEM, triggered administered pricing.

The AER is investigating whether generator bidding behaviour breached the National Electricity Rules during these high priced events. The AER is also investigating the flow limits placed on the Heywood interconnector by ElectraNet.

AGL Energy – TRUenergy asset swap

In the AEMC's review of the effectiveness of retail competition in South Australia, some interested parties have expressed concern with the generator market power held by AGL Energy in South Australia. Following its asset swap with TRUenergy in 2007, AGL has assumed ownership of South Australia's largest generator, the 1260MW Torrens Island Power Station.

In deciding not to oppose this asset swap, the ACCC recognised the potential for Torrens Island to be bid strategically into the NEM. The total installed capacity in South Australia plus potential imports during peak times is approximately 3660MW. As such, as soon as demand increases above 2400 MW AGL is the residual supplier and has significant ability to influence spot market outcomes.

However, the ACCC concluded that the merger itself was unlikely to result in a substantial lessening of competition in breach of section 50 of the *Trade Practices Act 1974*, because the previous owner, TRUenergy, already had the incentive and ability to exercise market power. It would appear likely that the recent combination of record demand and reduced interconnection would have led to high prices in South Australia regardless of whether the asset swap proceeded.

Looking forward

A key question is whether these high prices are likely to continue in South Australia into the future.

Generation capacity additions play an important role in easing wholesale prices. Aside from wind generation, Origin Energy's 120MW Quarantine Power Station extension is the only new generator anticipated to be available for the summer of 2008/09 in South Australia. Therefore, if South Australia faced extreme weather conditions again this summer, one would expect high wholesale prices.

However, in an energy only market like the NEM, wholesale price outcomes provide signals for future investment in generation capacity. To date, it appears that these signals have proven very effective in attracting new generation investment in South Australia, where capacity has grown by over 50 percent since NEM commencement. High spot prices around 1999 – 2000 fuelled new investment in peaking and intermediate generation in South Australia.

Recent high spot prices should similarly lead to further generation investment in South Australia. There are, however, some potential impediments to this generation investment materialising. First, the uncertainty surrounding the introduction of a Carbon Pollution Reduction Scheme appears to be dampening generation investment across the NEM. Second, generators who are not vertically integrated with a retailer may be deterred from investing in South Australia. This may be because there are difficulties in securing contracts with a customer of sufficient size to warrant generation investment in South Australia

Please contact me if you wish to discuss the issues raised in this letter further.

Yours sincerely

Steve Edwell
Chairman