4th August 2006

The Director
ERIG Secretariat
Level 4, 33 Allara Street
GPO Box 9839,
Canberra City, ACT 2601
By email: erig@industry.gov.au

Dear Ms Taylor

For attention of Financial Markets Reference Group

I write on behalf of the Energy Intensive Industries Alliance (EIIA) in response to ERIG's investigation for the Council of Australian Governments of measures that may be necessary to ensure that there are transparent and effective financial markets to support energy markets

EIIA represents the interests of industries where energy is a substantial proportion of production costs and is a significant contributor to their competitiveness. It represents the aluminium industry (through the Australian Aluminium Council), the cement industry (through the Cement Industry Federation), the plastics and chemicals industry (through the Plastics & Chemicals Industry Association) and the forest products, pulp and paper industries (through the Australian Plantation Products & Paper Industry Council).

Many member companies within the EIIA are also members of the Energy Users Association of Australia (EUAA). They have been involved in, and are supportive of, the EUAA submission on these issues which more comprehensively deals with some of the technical issues.

This submission has been prepared using assistance provided by the National Consumer Advocacy Panel and engaging the services of Coolibah Pty Ltd.

The major energy-intensive manufacturing sector contributes:
- 12 per cent of Australian gross domestic product,
- 12 per cent of full-time employment and
- 20 per cent of capital investment.

The sector accounts for about a quarter of Australia's primary energy consumption and about a third of national electricity consumption. Energy accounts for about 25 per cent of the sector's cost of production. Reliability and low cost of energy supply underpin this industrial base of the Australian economy.

The sector's companies are heavily trade-exposed to the global markets, dependent on competitively-priced energy to maintain a competitive edge and unable to readily pass through domestic cost increases to their customers.

They also provide the loads that stimulate the energy investment necessary to get power and gas in to Australian homes and smaller businesses and pay for a substantial portion of infrastructure development.

A significant issue for large energy users is the predictability of energy prices. This is a crucial input to budgets, pricing and market strategies and also capital investment programs.

In the Alliance's perspective, the key challenge of NEM reform is to ensure that the market is driven by the genuine needs of consumers and not the needs of consumers as interpreted by parties wishing to invest in supply infrastructure.

While the EIIA's principle focus in ERIG's activities is the urgent need to give importance and priority to policies that will develop the national (ie NEM) transmission network to provide users with a more efficient supply of electricity, the commitment by CoAG in February to implement national energy market structures to foster competition is also strongly welcomed.

In responding to the paper, EIIA notes that its three core issues of concern with the existing NEM structure are:

- the continuing dominance of government-owned energy businesses is most areas of the NEM;
- the heightened levels of ownership concentration in both the electricity and natural gas sectors and
- the way in which the exercise of market power lifts generator revenue above long-run marginal cost so that end-users pay excessive amounts for wholesale electricity.

From EIIA's perspective, the following points are worth the Financial Markets Reference Group's further consideration as it prepares this segment of the ERIG draft report for publication in October:

- Australia's compulsory electricity pool system (the NEM) can only work efficiently if it includes a vibrant and liquid market in financial hedging products. An important part of remedial action to achieve an efficient market is to deal with NEM price volatility which exceeds that in overseas competitive electricity markets. Price volatility increases the risks involved in market trading and eventually creates higher end-user prices as a result of suppliers (generators and retailers) having to pay for risk mitigation against the threat of high price spike levels. Studies have shown (cf Bardak, 2004) that as much as 20 to 30 per cent of annual NEM average pool prices are related to large price spikes occurring for barely one per cent of market operations. The Australian Government's white paper asserts that peaks lasting for only 3.2 per cent of the annual duration of the market account for 36 per cent of total spot market costs and argues that reducing the magnitude and cost of such peaks will reduce overall system costs.

- Market analysts have demonstrated that the NEM hedging market trades less than the physical volume of electricity sold, compared with more than five times the volume sold in the England & Wales (NETA) market and more than eight times in Nordpool.
- In the past four years the level of liquidity in the NEM has also been markedly affected by integration between private sector retail and generation businesses resulting in generation capacity being retained by the integrated business for its own physical hedging needs than being retained by the generator for contracting with rival retailers.
- The situation is exacerbated in the NEM as a whole by local actions of governments to protect public sector supplier operations (and taxpayers) from the risks associated with a competitive market, most notoriously with the New South Wales Government's ETEF scheme. ETEF, by providing government-backed hedging for government-owned retailers, lowers demand for derivatives by other market participants as well as causing other market distortions. EIIA seeks its abolition.
- The critical remedial step, as argued in the Alliance's submission to ERIG's Transmission References Group, is to deal with the lack of interconnection capacity in the NEM -- which has effectively turned the market in to five regional segments not the single, national market envisaged by the Heads of Government (the precursor to CoAG) in the early 1990s. Pursuit of this step will provide the opportunity for large-scale inter-regional contracting between generators and retailers. The capacity for generators and retailers to hedge spot price uncertainties will greatly influence the operational decisions and behaviour of generators, much reducing the incentives for them to engage in anti-competitive practices. EIIA notes that, in the PricewaterhouseCoopers review of Australian utility opinion, published in 2001, supplier executives argued that lack of liquidity in the wholesale electricity market is caused by inadequate inter-connectors and unstable market arrangements forming a "significant barrier" to adequate retailer management of risk.
- Policy decisions also need to be made with respect to integration of suppliers in the NEM and to disaggregation of State-owned generation businesses.
- The EIIA submission to the Transmission References Group outlines the steps the Alliance believes need to be pursued to establish stronger inter-connections, to prevent further supplier integration and to disaggregate government generation in order to deliver the power prices energy-intensive manufacturers see as important to maintaining their edge in global trading.

- The resulting considerably more free-flowing grid system -- the goal of the original National Grid Protocol agreed by Heads of Government -- will create a genuine market for economically-attractive hedging arrangements.

In this context the Alliance draws the Group's attention to an observation by MIT's Professor Paul Joskow (2005) to the effect that efficient transmission network operation and investment decisions are inter-dependent with the design, operation, incentives and price signals generated by the wholesale markets for power and ancillary systems.

While it is appreciated that CoAG has imposed tight deadlines on ERIG to deliver its final report, the Alliance recommends that the Financial Markets Reference Group endeavour to analyse more successful derivatives markets in overseas electricity markets to throw further light on the key aspects of the NEM that are impeding efficient risk management. Comparisons with Nordpool, NETA in England and Wales and the US Pennsylvania, New Jersey and Maryland pool will throw up, the Alliance suggests, that the key areas where the NEM compares poorly will include lack of participant diversity and lack of strong inter-connection arrangements.

The comments in this submission, EIIA believes, deal with the broad tenor of the key questions ERIG has posed with respect to financial markets so this contribution does not provide further comment on each of those questions.

In conclusion, from the EIIA perspective, the mission statement for ERIG can be reduced to three words -- "market power mitigation." The CoAG terms of reference for the Group do not state this in so many words, but EIIA suggests strongly that it should be the driver for ERIG in all aspects of its work, including consideration of financial market issues, and the Alliance looks forward to making further input when the Group's draft paper is published.

Yours sincerely

Miles Prosser
ON BEHALF OF THE **ENERGY INTENSIVE INDUSTRIES ALLIANCE**