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"Issues in Energy"

Good Afternoon ladies and gentlemen of Australasia.

As members or friends of the Trans-Tasman Business Circle your interests are obviously focussed on either doing or observing business on both sides of the Tasman and I'm sure you are all avid readers on the subject.

Right at the moment a lot of you will have read stories about " Issues in Energy" .

A quick glance at the stories about retailing electricity in Australia and New Zealand could lead you to believe the markets are the same.

Well, we all know you shouldn't judge a book by its cover, yet how often do we do just that?

The plots and the characters in the Australian and New Zealand stories may sound the same but today I'd like to use this opportunity to explain why they are so different.

Regardless of which side of the Tasman your interest lies, probably the main issue on everyone's mind in the energy sector is risk.

Peter Bernstein says in his book *Against the Gods*, "If everything is a matter of luck, risk management is a meaningless exercise."

We all speak about luck, good luck, bad luck, but you can't run a business based on luck.

So let me set the scene, by talking about risk in an electricity trading context.

Retailers have three options in addressing risk. They can manage the risk, price the risk, or avoid the risk.

As I think many in this audience will be aware, AGL owns 66% of the New Zealand based Natural Gas Corporation (NGC).

Today I'll cover the options NGC had in addressing their risk in the electricity market and how AGL is dealing with risk in the national electricity market in Australia.

But first a quick background on the establishment of the two markets. The New Zealand energy market relies upon competition law in the form of the Commerce Act as the only form of legislative oversight.

The New Zealand Electricity Market is a voluntary market that operates within a code of practice. The rules were developed through a unique process of consultation and voting by market participants.

The trading and dispatch functions are overseen by committees, but there are no representatives of either Government or consumer interests on those committees. There is no requirement for the market to account for its efficiency, because the market is controlled entirely by the firms that trade in it.

A body called the Market Surveillance Committee oversees compliance with the market rules.

When the New Zealand Electricity Market was set up in 1996 there was very little vertical integration of generation and retail.

Expectations were that the spot market would be used by organisations which were either a generator or retailer and the Electricity Corporation of New Zealand, at that time the sole major generator, agreed to issue hedges covering up to 85% of its output.

As events have unfolded, market structures have evolved in a very different manner.

Market rules in New Zealand are the responsibility of representative industry committees, but only 1 of the 7 members of the Rules Committee represents a net retailer.

A privately owned organisation operates the New Zealand Electricity Market, which has 8 power companies that are both power generators and retailers, with the now 4 largest, making up 84% of the market.

In New Zealand the conundrum is that there is a surplus of capacity in normal rainfall years but a lack of capacity in dry years.

About 60% of New Zealand's generation comes from hydro. And, unusually, they have peak annual storage of around 35 demand days, compared to hydro markets in Scandinavia and South America with, typically, more than 6 months demand cover. The Australian national electricity market is very different.

Australia's model features a number of state based and national regulators overseeing every move in the market place.

In Australia the Electricity Market is managed by a Government controlled company that was created by the State jurisdictions without direct involvement of the market participants.

Operating within in the Australian market there are currently 73 registered code participants.

And I would invite you to compare the hydro situation in New Zealand with the Australian situation where over 90% of electricity power generation facilities use either coal or natural gas as their fuel source.

The issue facing parts of Australia is the potential shortage of peak demand capacity in some states at very high demand times, typically for a limited period in mid-summer.

The pricing models in the two markets are also very different.

In New Zealand there is no maximum price set, but NGC had, in recent weeks, been experiencing unprecedented wholesale prices of over \$200 per MWh for most of the day. That's 3 to 4 times expectations of the average prices forecast by the well respected national energy forecaster Energylink, even taking account of the lower than normal hydro lake levels.

In Australia, there is a cap on the wholesale price of electricity at \$5,000 MWh. It is planned that this increase to \$10,000 MWh next April.

Here is an area of major difference between the two markets. In New Zealand base load generation comes from hydro and when lake levels are low the pricing mechanism is supposed to save water by signalling to thermal generators to bring all available plant on line.

In Australia our large base load generators are coal or gas and always underpin the bulk of the load. So peak pricing in Australia is driven by short term demand rather than constrained base load supply which in the New Zealand context had led to long periods of very high wholesale prices.

The problem in New Zealand is that the market rules are wrong because the solution doesn't address the principle problem which is that the market is vulnerable to drought.

Compounding the situation is that there are 244 price nodes in New Zealand. Coupled with high voltage transmission constraints this large number of pricing nodes leads to further unpredictability in pricing outcomes.

In Australia, electricity traders manage pool purchase risk at just four price node points, one each for New South Wales, Victoria, South Australia and Queensland.

Australian traders can purchase through secondary trading mechanisms, allowing retailers to see what the price is at each node and purchase at that price through a broker or other intermediary.

In New Zealand there is no effective secondary trading market.

Another difference is that the Australian market operates on real time, but in New Zealand actual prices are only known the day after.

It's a bit like buying a new car then finding out what you were going to pay for it on the day after you took delivery!

Let me describe how the New Zealand trading market operated last year and the first part of this year and the consequential impact on NGC.

NGC had hedges in place until the end of May and during mid 2000 and into 2001 sought additional hedge cover.

It found that the tentative deals on offer were very often withdrawn by the generator before they had received due consideration and/or the possibility of negotiation.

While some hedges were offered, these were out of the market and no one would have taken them up at that time, but assuming all offers of hedges either firm or tentative had been taken up, NGC would still have had at least a 40% shortfall to cover via the spot market.

The result was that no effective hedge market was in operation for that whole period, forcing NGC's exposure to the spot market.

In June of this year NGC raised these issues with the New Zealand Market Surveillance Committee

Last week the Committee released their findings on whether excessively high wholesale electricity prices were the result of a lack of fair and effective competition and whether there was what is described under New Zealand market rules as an 'Undesirable Situation'.

Unfortunately the Committee ruled that it could not find in the context of the operation of its rules that the market was in an 'undesirable situation'.

However as John Barton, CEO of NGC said, "This does not mean that the rules are right in the first place or that the market is functioning properly."

In fact, one can only wonder just what an 'Undesirable Situation' is when according to the Wellington Post this week the CEO of the Consumers Institute said, "We were promised choice, but right now we don't have it. The Government has to look very carefully at the situation today ... clearly changes need to be made."

As the Committee acknowledged that control of the rules rested largely in the hands of the net generators and that the market had not developed in the manner expected when the market was created.

It appears to me that inadequate weighting was given to the fact that the parties offering hedges were all retail competitors and that retailers were left with a 'take it or leave it' situation.

Little wonder then, that one commentator writing in NZ press last week said, "Our market is illiquid, far more than most overseas ones, so retailers are at the mercy of generators for even the simplest hedge contracts."

The issue also affects large customers, for example, Hawkes Bay's biggest timber processor, Pan Pac Forest Products, has just cut pulp production by up to 60% daily because it has had to pay up to 20 times more for electricity on the spot market as its time of use contract expired. This is by no means an isolated example.

Other comments from companies such as Infratil, Todd Energy, Comalco and TrustPower indicate that, they too, have similar concerns to NGC about the market rules.

Surely if the market rules result in net retailers being squeezed out of the market then changes must be implemented to ensure competition for all buyers and sellers.

Otherwise under current rules, business customers are likely to find energy costs rising dramatically, making New Zealand industry less competitive globally, thus creating a political problem.

Against the backdrop that I've described, NGC decided to exit the retail electricity market and concentrate on its other successful businesses where it does have a sustainable competitive advantage.

This was a case of deciding that the best course of action was to avoid the risk.

Now let me return to the Australian market.

There are hedge contracts available to retailers although pricing can be an issue at times of extreme demand.

I'm pleased to say that AGL has been very focussed on managing its trading book in Australia and I look forward to reporting on our Australian retail electricity businesses in more detail following the release of our annual results next month.

One of the keys for us has been identifying and quantifying the particular risks we face and the most efficient method of managing those risks.

Earlier, I mentioned the issue of the peak price for power in Australia possibly rising to \$10,000 a MWh in April next year.

In our view this is totally unnecessary.

With a peak price of \$5000 a MWh there is ample encouragement for new peak generation plant and right now, AGL is building 400 MWs of peaking generation plant in South Australia and Victoria.

These new plants will significantly improve AGL's ability to manage peak summer risk.

And of course the decision to build the plants is largely about managing risk.

On the sales side, in South Australia we have just finished a sales campaign under very difficult circumstances. 2,700 business customers there have seen price increases averaging 35% and up to 100%. These increases have been a direct result of higher wholesale power prices, coming from a tightening supply/demand balance in terms of energy used and hedge contracts available.

In this case, we employed a combination of managing the risk, by entering into hedge arrangements with generators and constructing our own peaking plants, and pricing the risk to cover any residual exposure we may have had.

This has been a very successful campaign for AGL with 60% of the contestable market now secured with the vast majority of customers signing five year deals, under-pinned by hedge contracts.

Notwithstanding that, the risk of a mismatch between pool prices and retail prices is certainly an issue for retailers, generators and consumers – and the answer in Australia parallels the answer in New Zealand, we must have a viable, robust hedge market.

Just as there are structural problems in New Zealand, energy market reform in Australia is also at a crossroads.

Governments need to hold their nerve as we enter the final stages of the introduction of competitive markets.

Public expectation, fostered by the needs of politicians, that energy market reform equals lower prices needs to be tempered.

Certainly, deregulation will result in more efficient markets, it will see the elimination of cross subsidies between customer classes and that necessarily means winners and losers. But it also introduces fairness.

We must have strong business rules to ensure all of our markets are operated in an open and honest manner.

As an example, it is pleasing to note the decision last week by the National Electricity Code Administrator to refer the practice of generator rebidding to the ACCC, asking them to put beyond doubt that generators are accountable under the Trade Practices Act. Currently some areas of generator operation are exempted from the that Act.

In Australia many of our retail energy markets are still not open to competition.

Contestability timetables are lagging and systems to manage customer switching are not yet ready.

Some Governments appear to be wavering on the introduction of an open market. We really are too far along the track now to turn back, but keeping control of the key issues along the way is going to be important.

And we need consistency and durability of regulation – constantly changing rules is worse than having no rules at all .

On the issue of regulation, in Australia at present we have eleven regulatory bodies looking over the shoulders of energy companies.

Surely it is time this process was simplified. The Trade Practices Act covers most competitive industries quite adequately, why not this one?

It is pleasing to see from the recent outcomes of COAG that our Governments are addressing many of the issues still outstanding in Australia.

We need to see further action on interconnections between states, a final commitment to contestability timetables in every State, a review of the peak power price, action on rebidding practices and all these issues are now on the COAG table.

The situation faced by NGC over recent months certainly brings home the importance of coping with risk. When you think about it dealing with risk related matters sits behind many business decisions.

In my opinion getting the balance right of avoiding, managing and pricing risk is a major focus in all successful businesses.

To finish let me use the words of Peter Bernstein again, "The essence of risk management lies in maximising the areas where we have some control over the outcome while minimising the areas where we have absolutely no control."

I'll leave you with that thought.

Thank you