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YK

2nd September, 2002

Mr Michael Rawstron
General Manager Regulatory Affairs – Electricity
ACCC
PO Box 1199
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Dear Mr ~~Rawstron~~ Mike

CHANGES TO BIDDING AND REBIDDING RULES IN THE NATIONAL ELECTRICITY CODE

1. Introduction:

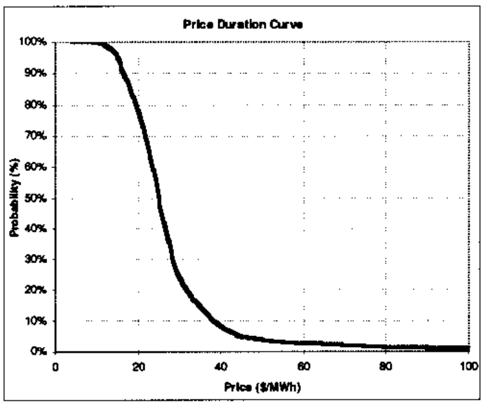
Eraring Energy is the third largest generator in the National Electricity Market ("NEM") in terms of capacity. Its assets include the Eraring Power Station (comprised of 4 x 660 MW units), pumped storage at Shoalhaven of 240 MW and other minor hydro and wind power stations. It should also be noted that, in terms of energy generated in 2001/02, and in fact since the start of NEM, Eraring Energy is the fourth largest, after Macquarie Generation, Delta Electricity and Loy Yang Power.

2. Market Spot Price:

The table below is a summary of the time-weighted average spot price since the commencement of NEM.

Period	NSW Time-Weighted Average Price – $/MWh
13/12/1998–30/6/1999	23.35
1998/1999	23.83
1999/2000	28.28
2000/2001	37.69
2001/2002	34.76

The graph below, which relates to the 2001/02 time period, shows the cumulative price distribution curve ie the percentage of time the spot price was above (or below) a certain value.



It will be noted from the above graph that the percentage of the time that the spot price exceeded $40.0/MWh was less than 10%. It will also be noted that over 80% of the time, the spot price was less than $31.0/MWh.

3. Long-run Marginal cost of Generation:

The long-run marginal cost of generation comprises the variable fuel cost and a fixed cost (comprising financing charges, depreciation and operation and maintenance costs).

For long-term sustainability, generators need income exceeding the long-run marginal costs. For a large coal-fired power station like Eraring, depending on the capital structure (level of debt, equity, etc), the long-run marginal cost of generation is typically around $38/MWh. This consists of fuel cost of typically around $15/MWh for NSW black coal and fixed costs of between $20/MWh and $25/MWh. The lower level fixed cost figure applies to a base-load power station ie a power station running at full load most of the time (ie, a high capacity factor). For mid-merit plants running at lower capacity factors, the fixed cost is towards the higher end of the range. Eraring Energy typically operates at a capacity factor of around 60% compared to the high-eighties and nineties of base-load power stations.

4. Eraring Energy as a mid-merit power station:

Eraring Power Station is the largest mid-merit power station in the NEM. Eraring Energy has a relatively high fuel cost compared to the base-load generators (>$16.50/MWh compared to Queensland coal costs of typically between $8/MWh and $12/MWh and brown coal costs in Victoria of typically between $4/MWh and $8/MWh). Eraring Power Station as a mid-merit plant requires that it is able to ramp up and down in response to changing load. Thus, it is an ideal mid-merit plant in the spectrum of generators. As such, it requires sophisticated rebidding to manage its position in the market.

It will be noted from the table in item 2 above that, in the case of Eraring Energy, the average annual spot price since the inception of the market has not exceeded its marginal cost of generation (taking into account an adequate risk-adjusted return on capital). This observation is further substantiated by the price duration curve showing the very low percentage of times that the price has exceeded the long-run marginal cost.

5. Eraring Energy's response to current market prices:

In light of the above situation, the only legitimate response of Eraring Energy is to bid in an innovative manner so as to help achieve spot price outcomes that would deliver income approaching the long-run marginal cost. With reference to the cumulative price distribution curve above, it can be observed that over 80% of the time, prices are below $31.0/MWh. In order to obtain an average spot price of $38.0/MWh, the remaining 20% of prices need to exceed $66.0/MWh. Alternately, there is a need for substantially higher prices over shorter periods to achieve the desired outcome. Eraring Energy's current bidding strategy is simply a commercial response to achieve prices approaching its long-run marginal cost and is, therefore, completely justified by the underlying economic factors.

6. Eraring Energy's view on current proposal:

Eraring Energy is concerned that, if the market freedom to rebid is removed or unacceptably restrained in order to regulate market volatility, it will further penalise mid-merit plants that provide valuable capacity support during periods of high demand. Operating at relatively low capacity factors and the low spot price outcome (over 80% of the time being below $31.0/MWh), it needs volatility to achieve commercially sustainable average price outcomes.

Eraring Energy does not agree with the view, expressed by the Commission in its draft determination, that basing rebidding decisions on the need to recoup long term marginal costs is "bad" or involves a generator "taking advantage" of market power in the "pursuit of profits".

Eraring Energy supports the analysis provided to the Commission by the NECG in relation to market power. In particular, Eraring agrees that a generator's need to recover fixed costs over the long run must be considered in this regard.

"Good faith" is an important element of the NEM, and Eraring Energy does not have an issue with the concept of "good faith". However, problems will arise if the concept of "good faith" is not defined, and is left open for interpretation by the individual market participants. This situation is clearly unacceptable, and should be addressed by the Commission.

Thus, if the Commission decides to allow the proposed Code amendment, Eraring Energy would like the Commission to provide explicit guidelines that clearly define the notion of "good faith" in the context of bidding and rebidding, rather than leaving this substantive issue to NECA alone.

Yours sincerely

Geoffrey

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MANAGING DIRECTOR