Australian Competition and Consumer Commission

APPLICATION for AUTHORISATION

for

A co-insurance arrangement between electricity Generators and Gentraders in NSW

A Response to the Draft Determination

by

The Major Energy Users Inc

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The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission. The content and conclusions reached in this submission are entirely the work of the MEU and its consultants.

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Executive Summary

The NSW government has long desired to sell its electricity generators and energy retail arms. It has not been able to achieve this because of resistance in some quarters.

To overcome this resistance the NSW government developed the concept of selling control of the output of the generators to a number of new trading entities – called gentraders. Perhaps in order to maximise the sale price of these gentraders, the NSW government has introduced the concept of co-insurance, exclusively for the use of the generators, and gentraders which is designed to increase the amount of firm capacity the gentraders might otherwise offer, and reduce the risk faced by the gentraders in the event they are unable to meet their firm capacity requirements. This would provide an exclusive benefit to the gentraders not available to other entities operating in the NSW region and elsewhere in the NEM.

The Applicants (Macquarie Generation, Delta Electricity and Eraring Energy) sought approval for this co-insurance from the ACCC by way of authorisations under the Trade Practices Act. To support its case the Applicants have offered that there is a net benefit from the arrangement and therefore it should be approved. The ACCC (as do all other submissions received in response to the application) considers there is no net benefit and has issued a draft decision to this effect.

Where a proposal is anti-competitive, it is incumbent on the proponent (in this case the Applicants) to prove beyond doubt that there are net benefits and to quantify these. The Applicants have not been able to convincingly provide that. They have not quantified the net benefit and, therefore, any assessment must be made on a qualitative basis exclusively.

A qualitative argument must be supported by empirical evidence that arguments made have a sound basis. In this case, the Applicants' arguments are not supported by evidence from the national electricity market (NEM). In fact, a number of the arguments made are effectively disproven by empirical evidence from the NEM.

The only assumption made that may have some foundation is that the sale price of the gentraders may be enhanced by the existence of the co-insurance scheme proposed and that the NSW government might reduce its risk exposure because of its existence. But this assumption is developed purely on a qualitative basis, so it is difficult to assess whether the benefit (if any) outweighs the anti-competitive detriment. The Applicants have an incentive to overstate the benefits in order to get approval from the ACCC. Because it cannot quantify the net benefit, the final assessment must be made on a qualitative basis, and as a result there is much opinion proffered.

In its submission, the MEU has provided empirical evidence from experiences large energy consumers have had operating in the NEM to support its contentions that the detriments of the proposal outweigh any benefits. In fact, in its analysis the MEU came to the conclusion that the benefits identified by the Applicants are probably less than appeared prima facie.

The ACCC draft decision clearly comes to the conclusion that the Applicants have not proven the case that there is a net benefit in allowing the implementation of the co-insurance proposal. In this the MEU agrees, and supports the ACCC draft decision which denies the Applicant's proposal to implement the co-insurance arrangement.

1. Introduction

1.1 About Major Energy Users

The Major Energy Users Inc (MEU) welcomes the opportunity to provide comments on the ACCC's draft determination concerning the authorisation applications by Macquarie Generation, Delta Electricity and Eraring Energy (Macquarie Generation and Ors) in respect of a co-insurance arrangement between electricity Generators and Gentraders in New South Wales.

The MEU comprises large energy using companies operating in the NEM and these companies have very substantial industrial operations in New South Wales (NSW). Following recent NSW network price increases in the order of 30% to 50% for 2010 (and further substantial increases expected over the next four years) arising from regulatory pricing determinations, NSW Government imposts (e.g. the Climate Change levy) and non-transparent network tariff setting decisions, MEU member companies have grave concerns that any NSW government 'energy reform initiatives' (such as co-insurance scheme associated with the gentrader model for selling NSW government owned generators) do not further undermine their cost competitiveness and raise the cost of doing business in the State.

1.2 The MEU assessment of the proposed approach

At its very basic level, what co-insurance does is to allow a select group (gentraders) to have access to firm generation contracts (providing access to generation capacity) from selected NSW generators. The reason for entering into the gentrader model, is that the NSW government was thwarted in its endeavour to sell its generators (Macquarie, Delta and Eraring). The gentrader model is intended to recreate a similar outcome to the thwarted sale process.

If the sale process had been allowed, the newly privatised generators would not have had a co-insurance scheme, but would have had to provide for their own firmness of supply through the same means as used elsewhere in the NEM. In this case, the NSW government would not incur any losses through the generators' inability to match the availability of its generation with the supply contracts entered into.

What the NSW government is seeking to achieve through its gentrader approach is to provide a third party (the gentrader) with the output of the government owned generators to trade on the open market. As the generator availability controls the amount of the output, either the generator has to accept the risk for its inability to match its output to the contract of supply to the gentrader, or the gentrader accepts this risk.

If the generator accepts the risk (as do generators throughout the NEM and where generators have the direct ability to control the risk) then the NSW government (as the generator owner) is exposed to the risk as its return from the generators would be reduced by losses incurred by each generator's inability to match its availability to the contracts it has in place with each gentrader.

If the gentraders accept the risk of generator availability then they are being required to accept a risk over which they have no control. Co-insurance removes the risk of generator availability from the gentraders and from the NSW government owner. But the risk still remains and it must be transferred to some other party.

The MEU sees the co-insurance approach is a way for the NSW government to transfer the risk of availability of their generators to consumers. Consumers have no ability to manage generator availability and therefore under the co-insurance approach, all of the beneficiaries (the NSW government, the generators themselves and the gentraders) of the approach pass all the risk and cost to manage the risk to consumers by way of increasing the cost of generation.

Co-insurance provides greater certainty for the gentraders and as a result it is expected by the NSW government they will bid higher prices for the rights to trade the generator outputs. This higher price would increase the NSW government revenue proceeds from the gentrader model sale process. But the cost of the co-insurance is carried by electricity consumers. This means that effectively the cost of the co-insurance becomes an indirect tax on electricity consumers. Indirect taxes of this kind increase the deadweight loss to the NSW economy.

The gentrader model with its associated co-insurance arrangements also adds another layer of complexity compared to privatising the generators. This additional layer of complexity will, no doubt, increase transaction costs for the whole sale process. These are costs that detract from the sale proceeds, as well as costs that would be borne by electricity consumers in the state.

1.3 <u>The initial MEU reaction to the application</u>

When the MEU first reviewed the application from the NSW government, it was very much in two minds about the issue. The fact that significant amounts of information in the NSW government was rather complex and some key information was not readily analysed made our assessment even more difficult.

From one viewpoint, the application had much to commend.. The MEU sees that consumers should benefit because:

- The introduction of five gentraders in place of three generators should lead to increased competition. However, this benefit is not dependent on the implementation of the co-insurance program. The two elements (gentrader and co-insurance) can be considered as not being mutually dependent.

- We have noticed in recent times that generators are contracting less of their output than in the past, with the result that some retailers have been unable to make offers for firm supply to their (larger) customers. This problem is not only a NSW issue, but more a NEM wide one. The co-insurance scheme might result in more firm capacity being made available in NSW, but this is not the region where the main problem currently occurs.

- Co-insurance should lead to lower costs for power from those benefitting from the co-insurance scheme. In practice, consumers see that the market price for power will be set by generators not able to benefit from the scheme and so the cash benefit will be taken by the gentraders as increased profit. As there is still a residual risk carried by generators and gentraders, it is highly unlikely that the benefits will be fully realised in the sale prices of the gentraders. As the sale of the gentraders will benefit the NSW government and not electricity consumers, there is seen to be little benefit overall that consumers will gain[1] with an overall deadweight loss to the NSW economy.

However, from another viewpoint, the MEU saw there were significant detriments for consumers, such as:

- There will be less competition, especially in the area of ancillary generation support services. Less competition tends to increase prices.

- Generation costs could rise over time. Having a co-insurance scheme has the potential to make both generators and gentraders less incentivised to exercise best practice in maintaining the physical plant to ensure maximum availability, especially as there is no financial driver (such as the cost of buying backup on the open market) to provide a clear cost benefit of best practices.

[1] Effectively the cash benefit the government receives for the sale of the gentraders (including the benefit of the co-insurance program) will become an indirect tax on electricity consumers.

- The scheme will result in less new generation being built in NSW and thereby drive up prices. NSW is currently a net importer of power, especially from Queensland – this shortage was clearly identified in the Owen review carried out for the NSW government in 2007. To further increase the amount of power needed in NSW either interconnection with other regions is needed (increasing networks costs) or more local generation is needed. If the co-insurance scheme is introduced, there will be a dis-incentive to build new generation, as the new generators will have to source their back up power on the open market rather than have the benefit of co-insurance available to incumbents.

- The very complexity of the scheme and the need for an Administrator to manage the use of the co-insurance scheme will inevitably increase costs, purely to implement the administration of the scheme, thereby adding another layer of costs. In fact, the absence of the co-insurance scheme will result in less costs for consumers to absorb.

Because of the apparent benefits and countervailing detriments, it was decided that MEU members should carefully consider the arguments for and against presented, so that they could come to a firm view. The outcome was that the additional costs of the proposal outweighed the benefits, which were seen as modest at best.

1.4 <u>The MEU overview</u>

As noted above the MEU sees that at first glance, there are appealing, pro-competitive aspects of the NSW co-insurance arrangement being linked to the NSW Energy Reform strategy, viz:

- The disaggregation of the NSW Government's three electricity generation portfolios into five gentrader portfolio bundles which will be sold through a competitive bidding process, marginally increasing competition.

- It allows the gentraders to better manage risks and to offer a higher level of capacity than they might otherwise have under the gentrader contracts alone

- The co-insurance arrangement was stated by the NSW government as being central to assisting a new entrant acquire one of the gentrader bundles.

In fact, the decision of the NSW government to develop the gentrader model is a direct result of its inability to sell the generators themselves due to resistance from some quarters. The NSW government had desired to sell the three existing generators (Macquarie, Delta and Eraring) in their existing form. Whilst selling the three generators into the private market might provide some minor competitive benefit, the MEU much preferred the NSW government to follow the Victorian deregulation approach, where each generator power station was sold individually so that generator competition was maximised.

The MEU considers that a first best outcome for the NSW government would be in maximising generation competition, by maximising the number of independent generators and breaking up the three generation companies into their constituent parts (e.g. Macquarie into two units of Bayswater and Liddell).

Overall, the MEU considers that the creation of five gentraders out of three generation companies should deliver some benefit in terms of competition to electricity consumers but more competition could have been enhanced by more disaggregation of the generator units.

The MEU agrees with the ACCC (and submissions received in the initial round of consultations to consider the issues) that it is appropriate to delink the proposed Energy Reform Strategy from the co-insurance arrangement, as the two are not mutually dependent. That is, it is essential to separately identify what are the real public benefits arising from the Energy Reform Strategy with and without the inclusion of the co-insurance arrangement to the gentrader model.

The MEU's comments follow the structure of the ACCC's draft determination document.

2. ACCC Evaluation

2.1 The Markets

The applicants consider that the relevant markets are:

- The NEM wide wholesale market for the supply of electricity and
- The retail market for the supply of electricity, being either an inter-regional market or a NSW wide market.

The ACCC's conclusion on the relevant markets is:

- The wholesale market for the supply of electricity is the NSW NEM region and the supply of products to mitigate against the risk of unfunded difference payments and
- The retail market for the supply of electricity being either inter-regional or NSW wide.

The MEU agrees with the ACCC's conclusion that the relevant wholesale market for the supply of electricity is the NSW NEM region.

The MEU has consistently maintained that the NEM is not an integrated market but a series of interconnected regions. The impact of the frequency, extent and severity of resulting price separations needs to be incorporated into all reviews of the NEM. That this is the case has been clearly demonstrated to consumers who seek contracts from generators from an adjacent NEM region (e.g. a SA consumer seeking a contract from a Victorian generator). Consumers are unable to contract in such a form as the exporting generator sees that the risk of a constraint on an interconnector is too great for it to be able to guarantee to be able to supply. If this occurs now in the NEM, then it is unlikely to change when the NSW government implements its proposed changes.

The ACCC is correct in pointing to congestion and physical constraints on the interconnectors between the regions (e.g. between Queensland and NSW). These have led to significant price separation across the regions.

As noted by the ACCC, in 2008/09 the NEM was not partially constrained at some point for only 70% of the time, implying the converse that there was price separation 30% of the time at some point in the NEM. For a supposedly fully integrated market, this degree of separation provides support for the MEU view that there is not an integrated market at all, and that the NSW region should be considered alone for the basis for assessing the co-insurance scheme.

The MEU points to the following table showing the extent and frequency of price separations[2] (which are quite significant) between NSW, Queensland and Victoria for the years 2006-2009:

Frequency of half hour price separations >$50/MWh	2006	2007	2008	2009
NSW and Queensland	157	414	146	209
NSW and Victoria	141	424	182	359
NSW concurrently with both Queensland and Victoria	32	87	20	108

Source of data: NEM Review

The table provides data which shows that effectively NSW is partially constrained from being part of the entire NEM on a regular basis (i.e. separated from either Queensland or Victoria), and frequently isolated (i.e. effectively unconnected to both Queensland and Victoria at the same time).

When the frequency of such separations is factored into the analysis, this supports the view that the NSW generation market should be seen on a regional basis rather than on a NEM wide basis.

However, it is not only the frequency of such separations but the severity of them that needs to be considered. When a separation occurs, it allows the regional generators to operate in a less competitive environment. Where one or more of these generators has market power, spot prices can be driven to very high levels. As discussed in section 2.4.2 below, the exercise of market power under the co-insurance approach is made more attractive, which will lead to significant transfers of wealth from consumers to generators and now gentraders, with resulting deadweight losses to the NSW economy.

To assess the impact of these partial and total isolations of the NSW region, in appendix 1 the MEU provides data (in a NEM wide format) which provides an indication of the severity of such partial or total isolation.

The tables included in appendix 1 show that when NSW is effectively constrained the price impact of the separations causes, on average, nearly 30% of the annual average volume weighted spot price in NSW.

[2] For the purposes of this analysis, where the price separation between regions exceeded $50/MWh, it is assumed that the interconnection between the adjacent regions is constrained

So, in simple terms, the relatively infrequent episodes of high regional prices, contribute to a significant part of the spot price seen by users of power in NSW.

In this way it can be seen that although the frequency of partial or total isolation of NSW from the NEM might be considered not to be substantial, the severity of the impact of that isolation makes such constraints an issue of major concern as they provide an opportunity and an incentive for those generators and gentraders protected by their co-insurance arrangements, to better exercise their market power.

Accordingly, the MEU agrees with the ACCC that the constraints on the interconnectors between NSW and the Victorian and Queensland regions indicate that a NEM wide geographic approach to the wholesale market is not appropriate in considering the impact of the proposed co-insurance arrangement.

The MEU also agrees with the ACCC that it "does not consider that the co-insurance product that is proposed by the Applicants is fundamentally different from the derivative products that are utilised by generators in the NEM to manage risk" (ACCC, p.28).

2.2 The Counterfactual: Applying the future "with – and without test"

The Applicants argue that:

- The co-insurance arrangement is a key element of the NSW Government's Energy Reform Strategy as it underpins the transaction in disaggregating into five Gentrader bundles.
- Without the co-insurance arrangement, the disaggregation into the five gentrader bundles is likely to increase the risk of unfunded difference payments.
- Without co-insurance, there will be an increased risk to the State owned generators of making availability damages payments under the Gentrader contracts and, as well, have adverse implications for the wholesale market outcomes and the ability of the Government to meet its target values for the Gentrader bundles.
- There are limited alternatives to co-insurance available to the gentraders to manage firm risk, although they concede that there are likely to be opportunities for the successful Gentrader bidders to enter another form of insurance or co-insurance arrangement once the sale process has completed, albeit with difficulty.

- In its February 2010 response to the ACCC queries and the submissions made to the application, the NSW government avers that:
    - The co-insurance is a core feature of the proposed reform, and that if it is not available, then there is a driver on the NSW government to reduce the number of gentrader bundles (page 2)
    - Whilst theoretically the counterfactual might apply, this does not mean that the absence of the co-insurance is possible or indeed likely as it is a government decision as to whether the program remains viable without it (page 4)

The ACCC's assessment of the counterfactual is that:

- There exist a number of options separate from the proposed arrangement available to the prospective Gentraders to manage their risk of unfunded difference payments; there is no information provided by the applicants to suggest that other generators operating in the NEM find alternative methods of managing risk (other than a co-insurance arrangement) to be lacking or unable to meet risk mitigation requirements
- There are also physical alternatives to managing firm risk (in addition to straight derivative products). Two of the Gentrader bundles – Delta Coastal and Eraring – contain peaking generators that would act as a natural hedge against firmness risk.
- The size of the Gentrader bundles will be relatively large compared to other assets in the NEM. The ACCC notes that for generation assets such as Bayswater that have four turbines it is common for them to manage firmness risk by adopting the N-1 model.
- Some of the potential bidders for the Gentrader bundles are likely to already have generation assets in NSW (or elsewhere in the NEM).
- Whilst a new entrant bidder for a Gentrader bundles may be placed at some small disadvantage compared to incumbent parties in managing risk, the lack of a co-insurance arrangement is unlikely to be a decisive factor in the new entrant's bidding behaviour. Other risk mitigation products would be available to a new entrant.

The MEU agrees with the ACCC's reasoning:

- **There are existing risk mitigation products/measures available, as detailed by TRUenergy, Snowy Hydro and Seed Advisory/Taylor Fay. That this is the case cannot be doubted, as in every other region, such co-insurance**

arrangements have not been permitted to occur. For example, the generators in Victoria and SA have been sufficiently segregated in the privatisation processes and subsequent sales so that such internal arrangements are no longer possible, forcing the generators to find alternative approaches to manage this risk.

- **Following from the above-mentioned point, the Gentrader model in the Energy Reform Strategy is not necessarily dependent on the co-insurance arrangement, i.e. the two elements should be delinked**

- **The co-insurance arrangement is anti-competitive, as it will:**

    - **Exclude the ability of other (independent) generators operating in NSW (e.g. Origin Energy's Uranquinty, TRUenergy's Tallawarra and Snowy Hydro's power stations) or elsewhere in the NEM from offering risk mitigation products to the Gentrader bundles unless such external offerings are priced lower than the cost of the co-insurance. If alternatives are lower priced, then there is no need for the co-insurance.**
    - **Equally, if the alternatives are higher priced, then the co-insurance scheme is innately anti-competitive. The arrangement will then provide the Gentraders with a commercial benefit that is not available to those generators competing in NSW and elsewhere in the NEM, as they are not afforded the benefit of the co-insurance scheme.**

2.3 Public Benefit – State focused

In its February response to the ACCC addressing the ACCC queries and stakeholder comments, the NSW government summarises (page 6) that the state focused public benefits are:

- "Delivering a competitive retail and wholesale electricity market;
- Creating an industry and commercial framework to encourage private investment in the NSW electricity sector reducing the need for future public sector investment in retail and generation;
- Ensuring NSW homes and businesses continue to be supplied with reliable and efficient electricity; and
- Placing NSW in a strong financial position by optimising the sale value of public assets and reducing the Government's exposure to electricity market risk and reducing the State's public debt"

These are all laudable goals but as the MEU pointed out to the Owen enquiry in 2007, the first three goals could be realised by the NSW government doing what the Victorian government did when it disaggregated the electricity market in the Victorian region – they increased competition by having all generation businesses disaggregated to individual generation sites. This provided an incentive for new generation investment because no one generator had the ability to control the regional market. In contrast, it has been seen that any one of Macquarie, Delta and even Eraring has the ability to exercise market power under certain demand conditions in NSW.

If the NSW government had disaggregated each generator to one business (e.g. Macquarie would become two businesses based on Bayswater and Liddell power stations with each still large enough to compete on a reasonable footing with others in the NEM) then the NSW regional electricity market would have already provided an environment where new retailers and new generators would be able to compete on a fair and equitable basis with the government owned entities.

As the ACCC and other stakeholders have observed, the introduction of the co-insurance scheme is not essential for the achievement of any of the first three benefits and would only have a marginal impact on the fourth and last point. The MEU agrees that if the risk of firmness of supply is managed by the co-insurance scheme, then there is some potential the NSW government might receive a higher sale price for the gentrader businesses than without it, although as discussed in section 2.4.1 below this is an assumption yet to be proven.

The MEU agrees with the ACCC that the relevant question that must be posed is whether the balance of public benefits and detriments that the co-insurance arrangement will generate, compared to the situation where the Energy Reform Strategy proceeded without co-insurance.

The ACCC notes that the Australian Competition Tribunal has stated that the term 'public benefit' should be given its widest possible meaning, including:

> "…anything of value to the community generally, any contribution to the aims pursued by society including as one of its principle elements…the achievement of the economic goals of efficiency and progress." (ACCC para. 4.6.3).

The Applicants consider that the co-insurance arrangement will result in:

- significant public benefits through improved market outcomes and
- benefits to the NSW Government and the NSW public, viz:
  - Encouraging new entry and thereby greater competition in the NSW generation sector
  - Improved wholesale level outcomes
  - Improved retail level outcomes
  - Value enhancement and cost savings for the NSW Government

The ACCC assesses that:

> "… in many cases there are market mechanisms available to manage firmness risk that will be equally and potentially in some cases, more effective and efficient than the co-insurance arrangement. Given this, there is also some question as to how widely the co-insurance arrangement will be adopted." (ACCC para 4.73).

The MEU supports the above ACCC assessment. The MEU is also not convinced that the co-insurance arrangement is necessary to the implementation of the Energy Reform Strategy and the disaggregation into the five Gentrader bundles. That this is the case is clearly supported by empirical evidence from the NEM that co-insurance does not exist in this form elsewhere in the NEM, and therefore it is not essential to allow the Gentrader strategy to be implemented[3].

As for the new Gentrader entrant, it is expected, should it commit to a significant new investment, that it will avail itself of expertise in risk management, knowledge and risk management products, given that the NEM is one of the most risky energy markets in the OECD area. This applies equally to the other four Gentraders – that they can do as all other generators and retailers do – use the existing market products to provide for the risk management and mitigation.

The MEU is not convinced that there is any public benefit in denying generators in the NEM with an ability to provide risk mitigation products to the Gentrader bundles to make available these products. All the stated public benefits from the Gentrader bundles model are likely to pertain with or without the co-insurance arrangement, in light of the availability of existing risk mitigating products/measures. As for the issue of value enhancement for the NSW Government, this is likely to

[3] In this regard, it should be noted that the NSW government had previously implemented the Electricity Tariff Equalisation Fund. As part of the ETEF, a similar form of co-insurance applied but the ETEF has been widely condemned as an anti-competitive measure, as it also drove generator bidding behaviour. Over time its use has been slowly discontinued.

be a short term measure. The implementation of the Energy Reform Strategy without any intervention and/or distortion in the risk mitigation market surely overrides the value enhancement claim.

Whilst the MEU (agrees with the ACCC and) concedes that there may be some value in a new entrant (given that the bundle may not be a large enough to self-insure) receiving the certainty of a co-insurance arrangement, it is likely to be limited and of short duration, in light of existing risk mitigation options. The MEU thus agrees with the ACCC that any such benefit in this respect is likely to be marginal, at best. In addition, the MEU (like the ACCC) is not convinced that the co-insurance arrangement will increase the level of firm capacity available at the wholesale level, above the level that would be available were the Gentraders to utilise one or a combination of the other existing risk mitigation products/measures.

The MEU also believes that improvements in retail level outcomes are not likely to happen in an environment where the co-insurance arrangement exists, assuming the Energy Reform Strategy proceeds. Retail competition flourishes when all retailers have equal access to firm supply arrangements and equal opportunity to access risk management tools on a competitive basis.

That this is the case is again readily demonstrated by the significant reduction of active retailers operating in the SA region, since AGL secured ownership of the Torrens Island Power Station, enabling the largest electricity retailer in the region to become the largest generator as well. Since this acquisition occurred, competition between retailers dropped significantly, and equal access to risk management tools also reduced markedly. The net result has been the reduction in numbers of retailers active in the region.

As to the benefits at the retail level that may result from a greater availability of firm contracts, the MEU agrees with the ACCC about the marginal benefits that might accrue as a result of the co-insurance scheme. Moreover, retailers could take mitigation measures, such as contracting for demand management participation with large electricity users. The effectiveness of such demand side provision of risk management tools should not be underestimated as such approaches are currently taking place as retailers and large users face decreasing volumes of firm capacity contracts and respond to market drivers accordingly.

2.4 <u>Public Benefit – market focused</u>

As noted in section 2.3 the MEU accepts that the Tribunal has given the concept of public detriment a wide ambit.

The applicants argued that:

- The co-insurance arrangement through encouraging a higher level of contracting will help avoid inefficient investment, which will ultimately be borne by customers through higher electricity prices.
- The arrangement does not limit the Gentraders from entering into other risk management arrangements with alternative market participants.

The ACCC's view is that:

- The arrangement forecloses on some opportunities for other providers of these services (e.g. fast start peaking plants) and it has the potential to impact the liquidity of supply of these services for other customers
- The arrangement will not result in higher levels of firm capacity being made available than would otherwise be the case.

The MEU considers that the market for risk mitigation products is likely to be distorted by the co-insurance arrangement.

2.4.1 <u>Impact on participating Gentraders, other generators and potential new entrants</u>

The Applicants argue that the co-insurance arrangement will not discriminate between different potential investors in new generation capacity. This view is more concisely made by the NSW government in its February response (page 7) to the ACCC.

> "Co-insurance encourages new entry both by facilitating disaggregation of the existing generation portfolios and also by reducing the risk of unfunded difference payments (which could act as a disincentive to new entrant investment). The NSW Government considers that co-insurance is particularly important to attracting new entrants because new entrants are likely to have fewer options to firm-up the capacity provided by the Gentrader contracts than do incumbent generators."

This response was triggered by Snowy Hydro and TRUenergy querying the applicant's contention that co-insurance will incentivise new entrant generators.

The MEU agrees with both TRU and Snowy that co-insurance is unlikely to incentivise new entrant generation. It is important to highlight that in the past four years, in the absence of such a co-insurance scheme, there has been the building or firm

commitment to build some 4800 MW[4] of new generation of which the bulk is by private entities such as Origin Energy, AGL and TRUenergy. This amount of new generation increases the amount of generation in the NEM by nearly 15%. None of these generation projects was supported by a co-insurance scheme to provide firmness of supply, so there is a clear argument that indicates that co-insurance is not a prerequisite for new entrants to build new generation[5].

In the early years of the NEM and its predecessor NEM1 (which operated only in Victoria and NSW) the immaturity of the market necessitated approaches like the Victorian VoLL Contract Repackaging (VCR) scheme. As the ACCC notes, although this was authorised to operate until the end of 2001, the fact that there was no significant attempt to gain an extension of the scheme, clearly indicates that the market had developed lower cost alternatives that had found acceptability with both generators and retailers.

The MEU finds that the arguments proposed by the Applicants do not reflect the empirical evidence that the NEM provides.

The ACCC's view is that the co-insurance arrangement will provide incumbent Gentraders with a means of managing risk that would not be available to any potential new generation capacity. That is, incumbent Gentraders will have a competitive advantage over all potential new investment, as well as over other incumbent generation assets (albeit limited).

The ACCC further goes on to state that (pages 43 and 44):

> "4.160. With respect to participating Gentraders themselves, calling on co-insurance is optional such that, all else being equal, it would be expected that a Gentrader would only use the co-insurance arrangement if they considered them a more effective means of managing risk than other available options. As discussed previously, the ACCC considers that, in at least some cases, Gentraders may not need, or even want, to use the co-insurance arrangement, particularly where the physical characteristic of their portfolio can be used as a natural hedge.

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4 See Origin Energy presentation to Reliability Panel February 2010 slide 10

5 In fact, Origin Energy, in its response to the Reliability Panel review on MPC 2010, clearly states that the prime driver of investment in new generation (whether for an existing generator or a new entrant) is a contract for output from a "bankable" counterparty. This bald statement does not support the NSW government contention that co-insurance will provide this incentive.

4.161. However, the arrangement is not entirely voluntary for Gentraders. The co-insurance arrangement operates under a surplus/deficit allocation system whereby the Gentrader who has called on co-insurance the most is the first to supply co-insurance to another Gentrader. In particular, during the initial period after the arrangement commences, where no Gentrader has a sufficient 'deficit' to be the first called on, Gentraders that have not called on co-insurance will be required to supply it. Similarly, where coinsurance is called on and Gentraders with a deficit are not able to supply all the coinsurance that is called on, Gentraders that are not in deficit may be obliged to supply co-insurance.

4.162. Therefore, in some circumstance Gentraders can, and likely will, be called on to supply co-insurance notwithstanding that they may have no need to call on co-insurance in return. To the extent that this does occur, Gentraders with a portfolio of assets capable of acting as a natural hedge, or who chose to engage in other strategies to mitigate risk, will be forced to forgo a proportion of their non-firm pool operating profit to compensate Gentraders who do not.

4.163. In this respect the ACCC notes that the arrangement cannot be dissolved without a super majority vote. The Applicants additional submission on 19 March 2010 indicated that the terms of the super majority were still in development, with each Gentraders vote likely to have regard to the capacity and/or expected availability of each Gentrader

4.166. Without further information on how the super majority will operate or be defined the ACCC is concerned that it may force a majority of Gentraders to participate in the coinsurance arrangement, at least to the extent of having to supply co-insurance when called on, despite them having no wish or need to participate in the arrangements."

The MEU agrees with the ACCC and the MEU, based on direct experience of MEU members operating in the NEM both in NSW and in other regions, finds the ACCC argument very persuasive.

Moreover, the arrangement appears to result in an exchange of much information not otherwise available to the market. There

is also a good deal of opaque understandings e.g. relating to the super majority and how it will operate.

2.4.2 Information exchange and Gentrader bidding strategies

The Applicants note that the co-insurance arrangement has been designed so that:

- It requires no communication of cost information between participants
- It places no obligation on the participants to bid in a particular manner
- A NSW Government-appointed Administrator will ensure that the arrangement does not facilitate coordinated behaviour.

The ACCC's view is that the co-insurance arrangement has the necessary features to prevent co-ordinated bidding behaviour between the Gentrader participants, but believes that it has the potential to impact on Gentrader bidding behaviour.

The ACCC said (page 45):

> "4.177. The non-pool operating profit the Gentrader called on is required to pay is calculated by reference to the Gentraders available non-firm capacity and the pool price. Accordingly, if the Gentrader has forward sold non-firm capacity at a price below the pool price at the time co-insurance is called on the Gentrader could be liable to fund the difference between the price they are receiving for their available non-firm capacity and the pool price.
>
> 4.178. Such potential exposure is likely to impact on Gentrader behaviour in contracting their non-firm capacity with the likely result that more non-firm capacity could be held back and bid into the spot market rather than made available through forward contracts."

The MEU agrees with the ACCC and other submissions in this regard.

The experience that MEU members have had in recent times supports the view that when a generator (or gentrader) can see there is a benefit in reducing the amount of generation offered to the market at cost reflective prices, but offering this at

excessively high prices[6] then it will do so. The outcome of this activity from a consumer's viewpoint is that in the medium term contract prices rise. There has been some very significant exercising of market power of this sort in recent years in NSW, Tasmania and most obviously in SA.

This supports our contention that given the necessary environment and opportunity, a business has the obligation to its shareholders to maximise the overall profitability of the business. If an opportunity presents itself, the business must use all legal means to maximise the benefit to the shareholders when there is an opportunity.

Because of this, there is an obligation on the developers of new market rules or arrangements to *prove beyond doubt* that the new rules will not reduce competition. The Applicants have not proven beyond doubt that the proposal will not allow a benefit to accrue to the gentraders that is not available to all their competitors which is not offset by the detriments it provides.

2.4.3 Generator incentives to maintain reliability

The Applicants said that reliability will improve by reducing exposure to plant outages and market risk. The ACCC considers that without the arrangement, generators will still have the same incentives to maintain or increase reliability.

The MEU agrees with the ACCC assessment of this view based on the MEU considerations expressed in section 1.

[6] This approach is termed economic withdrawal of capacity and has been used to spike the spot price when conditions are supportive of the approach. The result is that as the average spot price rises, the contract offerings from generators and retailers (and now gentraders) will quickly follow, increasing the reward generators (and gentraders will get from the market.

3. Balance of public benefit and detriment

The MEU agrees with the ACCC and other stakeholders that:

- The Gentrader model can be implemented without the proposed co-insurance arrangement because there are other options to manage the risk of unfunded difference payments.
- Including the co-insurance arrangement might result in at best, some marginal public benefit and but this is more likely to be negligible.
- It is not a more efficient means of managing firmness risk than other available options; any benefit is at best a short term, negligible, benefit.
- While limited in its scope, the arrangement will generate some public detriment
- Gentraders with a portfolio of assets capable of acting as a natural hedge provider, or who chose to engage in other strategies to mitigate risk, will be forced to forego a proportion of their non-firm pool operating profit to compensate Gentraders who do not.
- Whilst the arrangement potentially forecloses some opportunities for other providers of risk mitigation products, the effects are limited.

Overall, on page 49 the ACCC observes it:

> "… considers that the public detriment generated by the proposed arrangement is limited, the ACCC considers that the marginal public benefits of the arrangement would not outweigh this public detriment" (ACCC, para 4.204)

In conclusion the ACCC considers that it (page 49):

> "... is therefore not satisfied that the tests in section 90(6), 90(7), 90(8), 90(5A) and 90(5B) are met" (ACCC, para 4.205).

The MEU agrees with this conclusion of the ACCC draft determination.

Appendix 1

2009 data	Qld	NSW	Vic	SA	Tas	NEM (excl Tas and Snowy)
% of average annual volume weighted price caused by >$300 price spikes	24.2%	42.5%	34.4%	66.5%	31.9%	39.9%
% of average annual volume weighted price caused by >$1000 price spikes	23.5%	41.0%	34.1%	65.7%	27.9%	38.9%
Av annual time weighted regional price $/MWh	34.13	43.92	36.48	60.47	50.20	43.75
Av annual volume weighted regional price $/MWh	37.42	51.63	43.68	89.84	53.82	48.34
# price spikes >$300/MWh in 2009	42	89	37	129	103	297
# price spikes >$1000/MWh in 2009	33	56	27	78	64	196

2008 data	Qld	NSW	Vic	SA	Tas	NEM (excl Snowy)
% of average annual volume weighted price caused by >$300 price spikes	22.9%	14.1%	10.3%	57.1%	0.7%	24.3%
Av annual time weighted regional price $/MWh	43.87	39.12	40.24	66.37	49.73	47.41
Av annual volume weighted regional price $/MWh	48.81	42.13	43.45	92.70	50.67	47.70
# price spikes >$300/MWh in 2008	62	23	21	78	4	184

2007 data	Qld	NSW	Vic	SA	Tas	NEM (excl Tas and Snowy)
% of average annual volume weighted price caused by >$300 price spikes	25.9%	27.3%	19.7%	12.1%	4.5%	24.1%
Av annual time weighted regional price $/MWh	66.84	67.07	63.40	57.49	56.85	63.70
Av annual volume weighted regional price $/MWh	72.73	76.01	69.58	64.89	58.97	72.68
# price spikes >$300/MWh in 2007	160	213	132	78	36	583

2006 data	Qld	NSW	Vic	SA	NEM (excl Tas and Snowy)
% of average annual volume weighted price caused by >$300 price spikes	18.2%	20.6%	20.9 %	19.4%	20.1%
Av annual time weighted regional price $/MWh	25.97	31.01	34.13	38.68	31.02
Av annual volume weighted regional price $/MWh	28.23	34.81	37.65	44.68	34.49
# price spikes >$300/MWh in 2006	27	32	47	62	168

2005 data	Qld	NSW	Vic	SA	NEM (excl Tas and Snowy)
% of average annual volume weighted price caused by >$300 price spikes	19.6%	36.6%	7.6%	10.1%	24.6%
Av annual time weighted regional price $/MWh	25.17	35.83	26.29	33.60	30.22
Av annual volume weighted regional price $/MWh	27.12	40.84	27.83	36.76	33.44
# price spikes >$300/MWh in 2005	26	67	24	35	152