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Dear Michael

**PROPOSED REBIDDING CODE CHANGES  
FURTHER SUBMISSION FOLLOWING PREDETERMINATION CONFERENCE**

The NEM Contract Market

The draft determination express a number of opinions about the state of the contract market in delivering an overall efficient electricity market for customers. Particular comments include

*Most revenue in the NEM is earned through the contract market and market power is harder to detect in this market because of the relative lack of publicly available information about prices and volumes of contracts being offered and purchased. (at p6)*

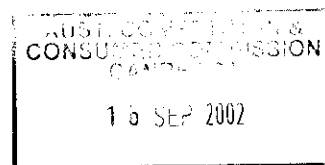
*Generator profits are made up of revenues from both the spot market and the contract market, but in the NEM, most revenues are made through the contract market. A generator can contract for greater amounts than its capacity, but in doing so it becomes a net purchaser from the pool and therefore has an incentive to keep pool prices down. On the other hand, if there is thought to be a level of market power in the spot market, there may also be concerns of market power being exercised in the contract markets as well. A generator may exercise its market power by choosing not to sell contracts and therefore not guarantee capacity. This implies a greater portion of generator revenue is coming from the spot market and that the generator is likely to have an increased incentive to game market outcomes. (p48)*

and

*Allegations of market power in the contract market were prevalent during the summer of 2000-01 but for the more recent bidding behaviour since May 2002 appear to have largely dissipated since that time. Generators were accused of not offering contracts or of offering contracts at unreasonably high prices. If market power were being exercised in the contract market during this time, contract prices above the new investment price would have been expected without any sign of new investment. However, the evidence in the NEM suggests that contract prices remain below new entrant prices in the main and that where prices have been high in the past, such as in South Australia and Queensland, there is investment occurring.*

*Much of the information used for assessing behaviour in the contract market is hearsay. Accurate information on contract prices and volumes is hard to obtain because such information is considered to be commercially sensitive. (p49)*

However the Commission then goes on to assert (without leading an issue or a benefit to this change)



*The Commission believes that consideration should be given to a regime of contract information disclosure where contract information is submitted in a confidential form to NECA. Such a mechanism could maintain the commercial sensitivity of the information while revealing the information to the market monitor in order to allow it to effectively monitor market behaviour in a more complete fashion. (p49)*

And at page 52,

*... .. there is limited information available on contract behaviour but evidence that is available suggests a more limited use of market power in the contract market.*

Each of these comments seem to (correctly) determine that there is no evidence of a contract market problem, but then suggest fixes to the information or sales aspects of this market. Importantly, the assertions of inappropriate use of market power in the spot market are assumed to flow into prices paid in the contract market, or that generators exert spot market power in order to achieve contract market outcomes.

The opinions are strongly at variance with both an examination of the competitive structure of the contract market and the observed price outcomes. Yallourn asserts there is **NO** evidence of market power in the NEM contract market, let alone any evidence of **abuse** of any such market power. Further, Yallourn assert that if there is any market power being abused in the spot market, it is having NO effect on the bulk of prices paid by customers - in the **contract** market.

## Structure

The economic concept of Perfect Competition is often criticised, due to the difficulty of obtaining its minimum conditions in a real world market. The most important of these conditions are perfect information, a large number of competitors and perfect substitutability of products between competitors.

A significant volume of energy in the National Electricity Market is traded via the OTC (over the counter) Market, and the most common product on this market is the standard “swap” or “contract for differences” product. These products trade for as little as 5MW from a month up to several years – quarters being the most common trade. Calendar 2003 (CY03) product has traded routinely over the last 12 months.

How does this product compare to the definition of perfect competition?

- **Perfect information.** The market uses a number of trading indices. These include those operated by the trade notification systems of the brokers, as well as the AFMA forward curve. These allow a range of price discovery points between the balance of the current month and 4-5 years out. In addition, each of the brokers and several market makers provide bid-offer spreads across the most commonly traded swap, cap and option products. These apply across all of the NEM regions.
- **Large number of competitors** In addition to the [20] generators and [10] major retailers, the market contains 6 brokers and several banks and other intermediaries. This is a large number of participants in comparison to other markets, in comparison to the size of the market, with the exception of the Nordic system.
- **Perfect substitutability.** All traded electricity products are identical. In a way that no two motor vehicles or tonnes of coal will have the same characteristics, electricity hedges have identical character. Even drastic differences between selling organisation credit quality can be eliminated with simple transactions. A 5MW Vic 2003 hedge

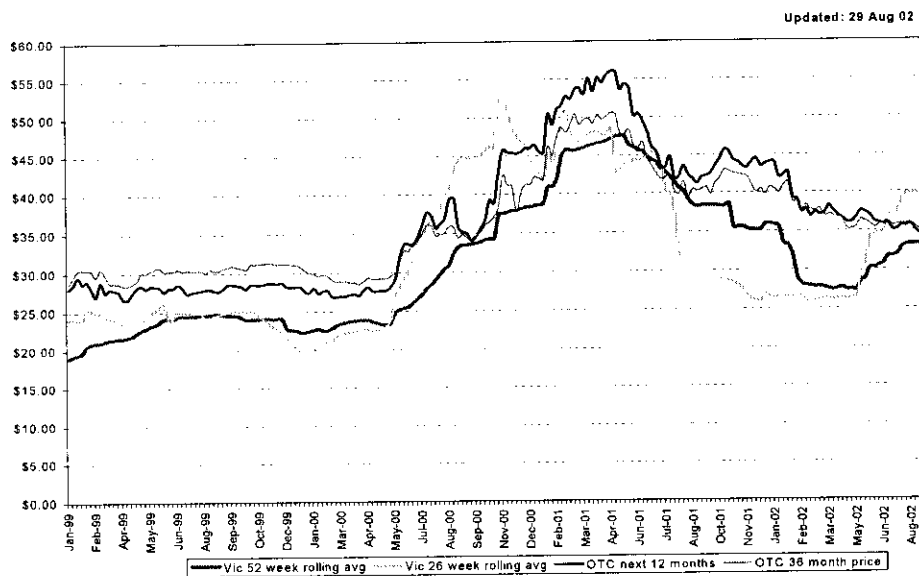
sold by Yallourn Energy is the same as from a Queensland retailer or a South Australian generator or a wind generator or a bank.

The Contract Market would therefore be expected to be very highly competitive, and therefore not supporting the assertions and concerns expressed in the report.

## Outcomes

The observed prices also support the very high level of competition in this market. One of the functions of the pool, when it is dispatching above SRMC bidding is signalling the value of existing and new capacity. This certainly occurred in the period up to Christmas 2001.

**Chart 1. Historical Vic OTC Contract Price** (source Yallourn Energy)



In the above graph, OTC means the mid spread price of a 5MW swap/hedge for the next 12 months, 36 month OTC means the same product but for a 3 year period and the averages are rolling 52 week and 26 week VIC pool prices.

This graph shows

- The strong correlation between medium term pool price and OTC in the 99 and 00 calendar years (CY)
- The stress in the pool due to equipment failure and industrial relations issues in winter 00 and corresponding reaction in the OTC
- Extreme signalling in the 01 summer in both OTC and Pool
- Relaxation in the OTC after commissioning of 720MW of peaking capacity in VIC and SA

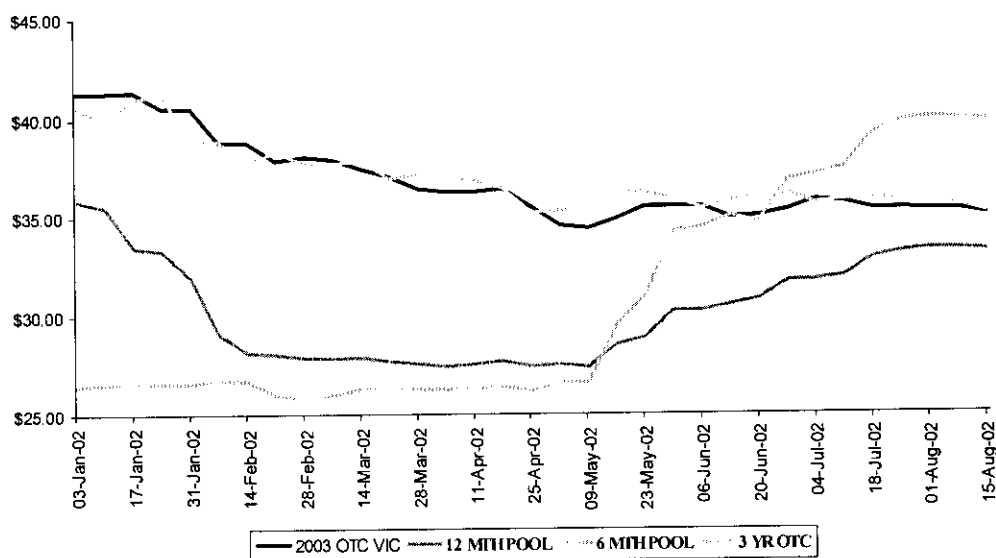
- acceleration of average pool prices associated with the demand surge and operation of ETEF in May and June 02, accompanied by a LACK of movement in the OTC, indeed, a continued relaxation of the OTC in Victoria. An identical position exists in NSW.

Clearly, the OTC market is not operating as a slavish (and unsophisticated) pool plus a margin mechanism in a period where the response of the pool, or factors that the pool is reacting to or pricing, do not **necessarily** lead to a forward **capacity** signal.

Where the contract market has signalled high prices in 2001, this has been followed by competitive asset entry into the generation market. Apart from the problems associated with industrial relations, these generators have faced little or no entry barriers and were built well within the normal 12-1=24 month lead time.

Is the situation different in other regions?

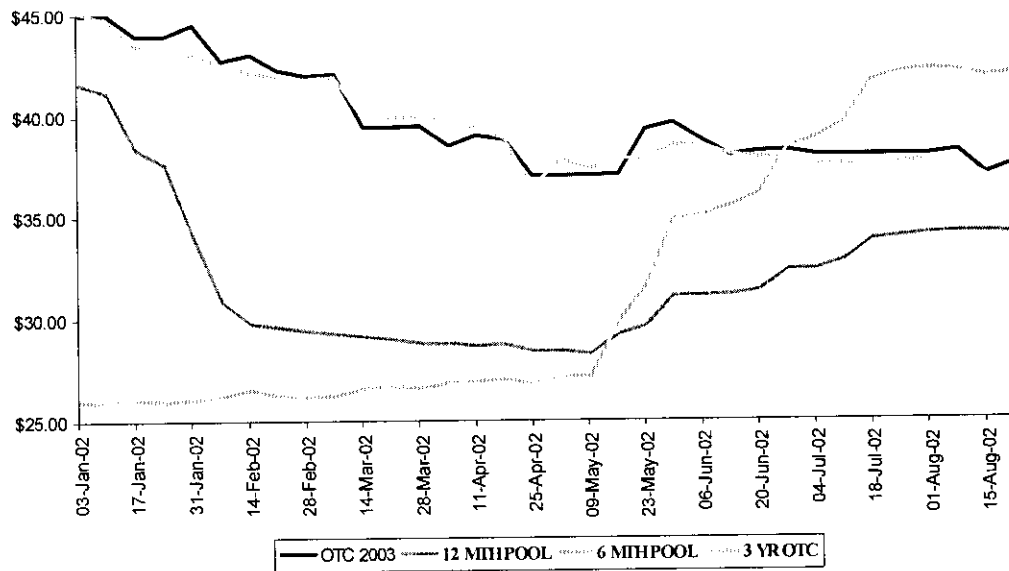
**Chart 2. Vic 2003 OTC Price & Pool Averages** (source Yallourn Energy)



The above graph extracts the Victorian information, and focuses on the post January 02 period, so as to highlight the effect, or lack of it, from the May June price peaks. Clearly, there is no OTC reaction to May and June pool effects.

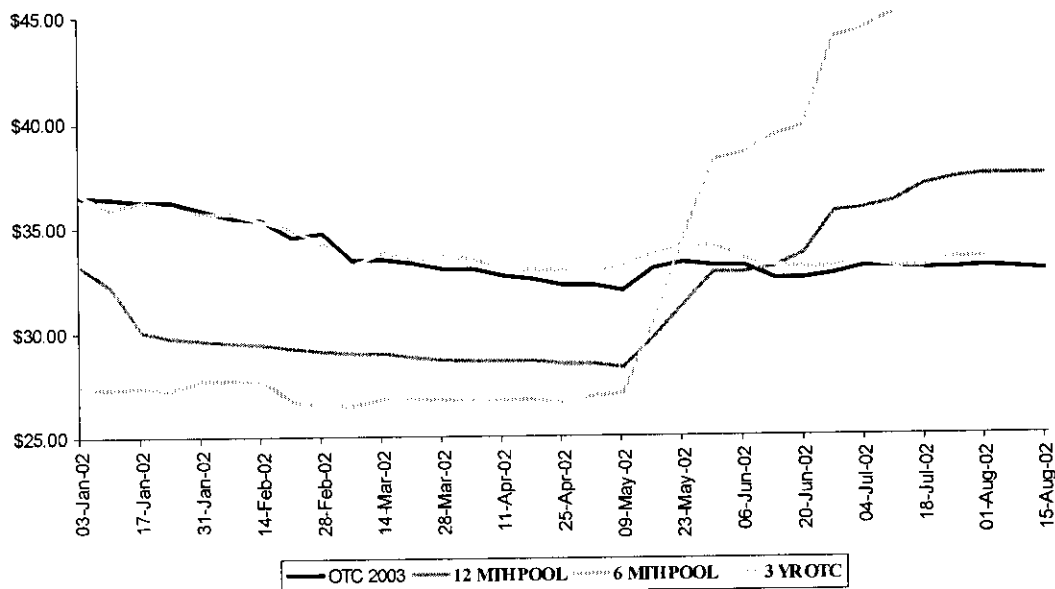
The effects of the pool price outcomes on the price averages is most evident, as is the non reaction of the contract market. It is worthy of note that the pool average is still below most assessments of LRMC and New Entrant Price.

**Chart 3. SA 2003 OTC Price & Pool Averages** (source Yallourn Energy)



Again, while the effect of the NSW demand surge and ETEF pricing flows into the SA pool, it has had no effect on contract prices paid in South Australia.

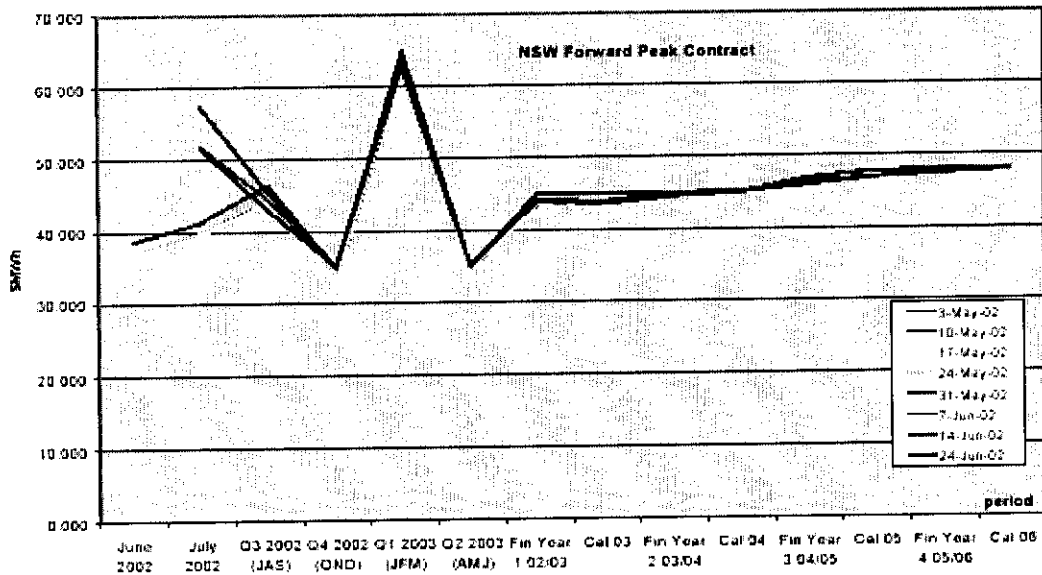
**Chart 4. NSW 2003 OTC Price & Pool Averages** (source Yallourn Energy)



NSW shows the most extreme effect of the May and June pool pricing. Again, there is little or no flow through into the contract market, and price has remained below the capacity signalling point at LRMC or New Entry Pricing.

### Draft determination Appendix 3

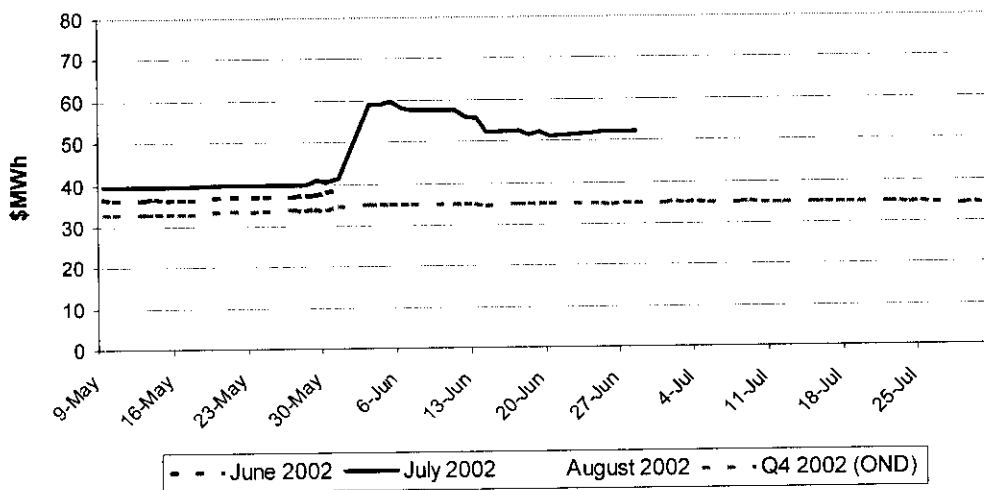
The draft determination suggests at Appendix 3 that the effect of the price volatility in May and June 2002 had been to put Contract prices up, and by extension therefore increase prices paid by customers. The following NSW graph was used as evidence, and similar plots were produced for the other states.



The first observation that can be made is the very limited effect that the price effects observed in the pool have had on the contract market, in that observed Peak price for the next month (July) went up by \$10-12 (or 41%). Over a year, this movement represents a \$0.50 increase in an annual contract. It can be observed from the reproduced graph that in fact the movements in the longer dated contracts were minimal.

Chart 6. NSW Peak OTC Price 2002

(source AFMA)



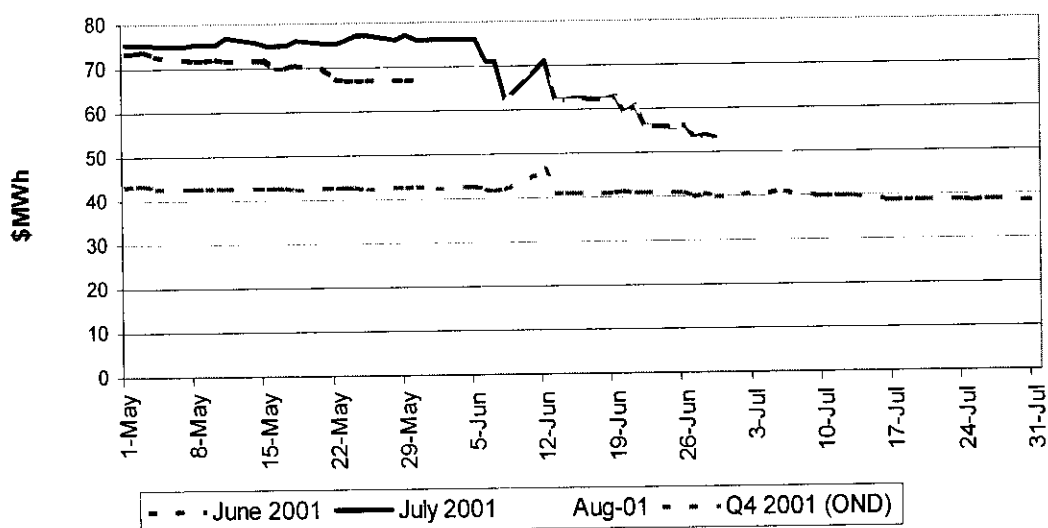
The above graph shows the same data (for June and July), with the addition of the August Contract. This graph shows a sharp increase in July peak contracts, but no effect on August.

Again, July Peak represents 4% of a year a \$20 jump in price is equivalent to an \$0.80c annual impact.

Investigations conducted by Yallourn among all the OTC brokers during the week of 3 September revealed that one 5MW contract for July Peak traded. Although bilateral trades may have occurred that did not therefore get reported through the brokers, it would appear that the effect reported by the Commission in Appendix 3 was confined to one month, and affected one trade that represented approximately 0.54% of average demand in NSW for that month.

**Chart 6. NSW Peak OTC Price 2001**

(source AFMA)



The above graph shows the same data for the same months, but for 2001. What therefore happened in 2002? Was this an artefact of bidding behaviour in May and June 2002 or a return to correctly valued mid Winter contract values? While the contract market was pricing for a normal winter after an extreme summer, all the 2001 winter prices are lower than 2002. If there is a market power problem, why did the final (highest) 2002 July Peak price turn out lower than the lowest 2001 price? And if so, why is the 2002 August below August 2001?

## Conclusions

- There has been no evidence lead in the draft determination that there are any “problems” in the contract market, and certainly no evidence of the standard that would be required to justify regulatory intervention in this market.
- The structure of the contract market is such that it would be surprising if a theoretical examination found a rationale for intervention to improve competition in the contract market.
- Where the contract market has signalled high prices, this has been followed by competitive asset entry into the generation market.
- Pool prices in 2002 that in Yallourn’s view that were associated with intervention in the form of the ETEF structure did not have effects on the contract market prices.
- Assertions in the draft determination of an inappropriate link between pool and contract prices relating to price increases for the July 2002 contract are confined to a

microscopic effect on indicated prices, and do not reflect either an alteration in prices for Q3 (as shown on the Commissions own Appendix 3 data) or even on the next month prices. These prices are radically lower on the winter prices that prevailed in a period not affected by ETEF spikes in the previous year.

There is no justification for regulatory interference in the NEM contract market.

Yours sincerely

**YALLOURN ENERGY**

A handwritten signature in black ink, appearing to read "Andrew Bonwick". The signature is fluid and cursive, with a large initial 'A' and a long, sweeping tail.

**ANDREW BONWICK  
MARKETING DIRECTOR**