New South Wales Government
ENERGY REFORM STRATEGY

Further submission in response to the ACCC questions and third party submissions

in relation to the co-insurance arrangement for the Energy Reform Strategy

Introduction

The NSW Government has first addressed the issues raised by the ACCC, before turning to some of the additional issues raised in the submissions lodged by Snowy Hydro, TRUenergy, and Seed Advisory and Taylor Fry.

Many of the issues raised in the interested party submissions have been addressed in detail in the Government's original supporting submission lodged with the authorisation application (***Submission***). In responding to those issues, the Government has refrained from repeating the information set out in the Submission but has instead cross-referenced the relevant section of the Submission.

If there are any issues raised in the interested party submissions that the ACCC would appreciate further comments on from the Government, please let us know.

ACCC questions

Acquisition of Gentrader bundles

Is it the intention of the Energy Reform Strategy that the bidders for the Gentrader bundles will be limited to only acquiring one bundle each?

It remains the Government's intention under the Energy Reform Strategy that bidders be limited to acquiring one Gentrader bundle. In this regard, it is important to note that the co-insurance arrangement is a key element of the Energy Reform Strategy and integral to this limitation. If there is no co-insurance then the Government may need to consider re-aggregation of the Gentrader bundles or other changes to the Energy Reform Strategy (such as lower target availability levels[1] under Gentrader contracts, which will have an impact on the wholesale electricity market as well as the value of the assets being sold).

Impact of co-insurance on other generators

The ACCC is interested in [the Government's] views on the impact of the proposed arrangements on generators that otherwise may have wished to have participated in the co-insurance arrangements but are not able to due to its exclusive nature and generators that may have been engaged by the Gentraders to manage risk through their physical capacity (i.e. fast start peaking generators)?

As a preliminary matter, it is important to note that the "exclusive" nature of the co-insurance is simply a function of the Energy Reform Strategy and the particular assets being sold by the Government. Co-insurance has been designed to support the Energy Reform Strategy and the participants in co-insurance will be the Gentrader and Generator counterparties for the relevant Gentrader contracts. The exclusive nature of the co-insurance is limited: as discussed below, it does not prevent Gentraders from entering into risk management arrangements with other market participants.

Additionally, even if the co-insurance could be extended beyond the particular Generators and Gentraders, the inclusion of high marginal cost generators such as fast start peakers would render the co-insurance less effective to mitigate the risk of unfunded difference payments. This is because the co-insurance strike price would have to be high enough to cover the marginal cost of those generators. In other words, with fast start peakers in the scheme, participants would not call on co-insurance until the spot price exceeds the peaker's SRMC, i.e. the co-insurance strike price. Given the SRMC of a peaker is in the range of $50-$60/MWh, this means that Gentraders will be subject to outage risks when spot prices are below this level and above their own SRMC (which ranges from $10-$20/MWh). This is the reason for the Government excluding two of its own fast start generators from the scheme: Colongra and Shoalhaven.

[1] The concept of target availability under the Gentrader contracts is discussed further below; see also the NSW Government Submission, Part C, section 2.4.

The co-insurance arrangement is not exclusive in the sense that it does not prevent Gentraders from entering into risk management arrangements with fast start peaking generators or from seeking other risk management products from other market participants. In particular, Gentraders may still seek risk management products from fast start peakers if they wish to sell contracts above the co-insurance firm capacity level. Nor does the co-insurance prevent fast start peakers from competing to provide hedging contracts to retailers and end-users.

In any event, if there was no co-insurance arrangement, there is no guarantee that Gentraders would seek to acquire risk management products from fast start peakers in a re-aggregated scenario (given the self insurance option) or even in the current five bundle scenario (as Gentraders may adopt an n-1 contract strategy) .

It should also be noted that there is a very substantial number of generators and generation capacity in the National Electricity Market (***NEM***) to which the co-insurance will not apply.

Finally, in terms of assessing the impact of co-insurance on competition it is important to note that the impact on any particular market participant or group of participants, including fast start peaking generators, is but one aspect of competition. Any potential impact on individual market participants needs to be assessed against the benefits of co-insurance to other market participants (including, retailers and consumers) and the competitiveness of the relevant markets overall.[2] Further to this, co-insurance is an essential element of the Energy Reform Strategy and, as such, the impact of co-insurance on any particular market participant needs to be assessed in the context of the entire Energy Reform Strategy and against the relevant counterfactual.[3]

The present position is that the NSW generators are all commonly State owned and run as three (not five) separate integrated businesses. Competition in the relevant market will be enhanced by the Energy Reform Strategy due to the disaggregation of the large NSW base-load generation portfolios (thereby reducing their market position) and the new entrant requirement.

Impact on firm capacity

What is the estimated level of firm capacity if there is no co-insurance arrangement?

The co-insurance arrangement will provide Gentraders with a defined level of firm capacity on the half hour that would not otherwise be available. Without co-insurance, Gentraders would be exposed to a risk of outage for the entire capacity provided by the Gentrader contract – although the risk of simultaneous outages of multiple units would mean that some part of this capacity could be considered notionally firm.

Specifically, if there is no co-insurance arrangement, Gentraders will not have any contractual firmness as the Gentrader contracts do not provide Gentraders with firmness on the half hour. The Gentrader contracts will specify availability targets which will be set for separately defined periods (e.g. working weekday peak periods) consisting of a number of months. As long as the Generator meets the required availability target over the period of months, unavailability for any particular half-hour during the period will not expose the Generator to penalties under the Gentrader contract.

The co-insurance supports the availability targets in the Gentrader contracts. If there is no co-insurance then the Government would need to consider reducing those targets or making other changes to the Energy Reform Strategy (such as re-aggregation of the Gentrader bundles). Co-insurance allows the Government to offer an increased level of firmness for a given expectation of making penalty payments under the Gentrader contracts.

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[2] These benefits are discussed in the NSW Government Submission, Part C.

[3] See further NSW Government Submission, Part A, section 4.3 and Part C, section 1.

Third party submissions

Market definition

The Government does not agree with Snowy Hydro's submission that the relevant market for the purpose of considering the co-insurance authorisation application is the market for insurance products that mitigate against unfunded difference payments for NSW generators.

First, while the form of the co-insurance arrangement may not be that of a standard electricity derivative contract, the substance and purpose of co-insurance is intended to work as an electricity derivative contract. Market participants in the NEM have the ability to purchase electricity derivatives to manage unfunded difference payments in the form of swaps, caps, options or a combination of these.[4] Co-insurance has been established to achieve exactly this objective.

Second, co-insurance and standard derivatives are not fundamentally different products as claimed by Snowy Hydro. They both serve the same objective which is to manage the risk associated with volatile spot prices. They are both settled by reference to the spot price. While a standard derivative has an agreed strike price, co-insurance has a pre-determined co-insurance price. Similar to a derivative contract and unlike a typical insurance contract, under co-insurance there is no payment of a premium regardless of whether the insured event occurs.

Third, as is apparent from Snowy Hydro's submission, whatever the form of the co-insurance the relevant market for assessing the effects of the co-insurance arrangement is the NEM.

Relevant counterfactual

Contrary to the submissions made by Snowy Hydro and TRUenergy, the mere fact that at a theoretical level the Energy Reform Strategy could be implemented without co-insurance does not make this the relevant counterfactual.

Snowy Hydro and TRUenergy are not in a position to say what would happen to the Energy Reform Strategy if there was no co-insurance. This is a matter for the Government. The Energy Reform Strategy has been designed to achieve a number of objectives and the co-insurance is a key element in enabling the Government to meet those objectives. If there is no co-insurance, then in order to achieve its objectives the Government would need to reconsider the Energy Reform Strategy, including disaggregation of the generation assets through the five Gentrader bundles.[5]

Alleged anti-competitive detriments

Impact on market participants

The interested party submissions significantly overstate the impact of the co-insurance arrangement on market participants.

The co-insurance arrangement will benefit market participants as it will facilitate liquid markets for the supply of electricity derivatives in the NEM. The disaggregation of the three existing State-owned generation portfolios into the five Gentrader bundles is likely to result in less firm contracts being offered to the market. Co-insurance aims to alleviate this problem as it provides the opportunity (but not the obligation) for Gentraders to offer a greater quantity of firm hedging contracts to the market for a given level of risk. The co-insurance arrangement facilitates competition between the Gentraders and other generators in the NEM by providing the Gentraders the opportunity (but not the obligation) to offer a greater quantity of firm

[4] As Snowy Hydro in fact acknowledges in section 2.4 of its submission.
[5] See further NSW Government Submission, Part A, section 4.3

hedging contracts to the market than would otherwise be the case and thereby facilitating more liquid contract markets. This in turn has benefits for competition in retail electricity markets.

Whilst co-insurance will lead to greater liquidity, it will not prevent Gentraders from entering into other risk management instruments. As noted above, Gentraders may wish to enter into other such instruments to "firm up" their capacity above that provided by co-insurance.

Information exchange

Snowy Hydro and TRUenergy both make submissions to the effect that co-insurance will facilitate the exchange of information that may create incentives for less competitive behaviour on the part of the Gentraders. The co-insurance arrangement has however been specifically designed to limit information flows between parties to the arrangement. See further page 36 of the Submission and the detailed information regarding the operation of the co-insurance arrangement at Appendix 1 of the Submission.

Power station reliability

Co-insurance will not undermine incentives to maintain or increase generator reliability. The co-insurance arrangement has been designed to preserve incentives on both Gentraders and Generators to maintain and increase generator reliability. As set out in the Government's submission,[6] Gentraders benefit from more reliable power stations because they will be able to better retain non-firm operating profits. Generators benefit from reliable power stations because it reduces the co-insurance payments that they are required to make during an outage and increases the chance that they will supply co-insurance and receive payments. In this way, the co-insurance arrangement supports the Gentrader contracts, which also provide Generators with incentives to maintain and increase reliability.

The comments made by Snowy Hydro in their submission in relation to this issue[7] assume that the co-insurance arrangement does not take account of differences in generator reliability, when this is not the case. In setting the level of firm capacity provided under the co-insurance arrangement, the reliability of particular power stations will be taken into account. It is not the case that the benefits of reliability for a newer more reliable generator will be captured by less reliable generators. In any case, the incentives that Generators have to maintain and increase reliability under the Gentrader contract and the co-insurance arrangement do not depend on the level of firm capacity under the co-insurance arrangements.

Impact on spot markets

Snowy Hydro alleges that co-insurance will create incentives for co-ordinated bidding behaviour in the event of a forced outage as Gentraders that are called will have incentives to bid at SRMC. As discussed, the co-insurance arrangement has been specifically designed to limit information flows between parties so that the co-insurance arrangement does not promote co-ordinated behaviour. It is also important to note that the Gentrader contracts are being designed so that Gentraders will face variable payments that reflect the variable costs of operating the power stations. In other words, the Gentrader arrangements will not result in uniform SRMC across the State-owned Generators. In any case, stronger incentives to bid at SRMC would mean that the spot market will become more competitive not less competitive.

Deferral of investment in new generation

It is has been suggested in the interested party submissions that co-insurance could defer investment in new generation. As set out in the Submission, co-insurance will have no impact on the supply-demand balance which is the underlying pre-condition for new investment. Co-insurance will simply ensure that more efficient use is made of existing generation capacity.[8]

Public benefits

Relevant public benefits

Both Snowy Hydro and TRUenergy misrepresent the Government's submissions regarding the public benefits arising from the co-insurance and in particular the benefits to the State of NSW.

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[6] See further NSW Government Submission, Appendix 1.

[7] Snowy Hydro submission, page 9

[8] NSW Government Submission, Part C, sections 4 and 8

In addition, in their submissions Snowy Hydro and TRUenergy fail to appreciate the broad concept of "public benefit" for the purpose of the authorisation test. As set out in the Submission, for the purpose of assessing an authorisation application "public benefit" refers to "anything of value to the community generally".[9] Accordingly, to be a public benefit, it is not necessary that it be a benefit to the Australian public as a whole – even "private" benefits can be public benefits.[10] Nor is it necessary that the benefit be one resulting from greater economic efficiency.[11] The benefits set out in the Submission and discussed below are all relevant public benefits for the purpose of the authorisation test.

Supporting the Energy Reform Strategy

The Energy Reform Strategy is the means by which the NSW Government will exit electricity markets. This will bring significant public benefits, both to electricity markets and more generally. Specifically, as set out in the Government's Strategy document, the Energy Reform Strategy has been designed to meet the following objectives:

- 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.[12]

In order for the Energy Reform Strategy to proceed the NSW Government's value objectives must be met. As such, the value of the Gentrader contracts is integral to the overall success of the Energy Reform Strategy and the benefits of that Strategy cannot be isolated from the benefits of enabling the Government to offer more valuable Gentrader contracts to the market.

Both Snowy Hydro and TRUenergy question whether the co-insurance arrangement will lead to higher sale values for the assets. As set out in the Submission, co-insurance increases the value of the Gentrader bundles by reducing the risk of Gentraders being exposed to unfunded difference payments thereby enabling Gentraders to offer more firm contracts. The NSW Government expects that co-insurance will increase the sales value of the assets by attracting a broader field of bidders. The Government can provide further information to the ACCC in support of its position if required.

Snowy Hydro has also suggested that the cost of the co-insurance arrangement will be an issue. The costs of the administration of the co-insurance arrangement will however be moderate. It is expected that the arrangement will be able to be largely administered with relatively simple automated systems.

Facilitating liquid contract markets

Whilst acknowledging that co-insurance will increase firm capacity and promote more liquid contract markets, both Snowy Hydro and TRUenergy question the benefits arising from this and suggest that these benefits could be achieved in the absence of co-insurance. There are a number of issues with the submissions made by Snowy Hydro and TRUenergy.

First, there is a failure to appreciate the nature of generator availability (as opposed to firm capacity on the half hour) under the Gentrader contracts in the absence of co-insurance. In this regard, the Government refers to the comments above in response to the ACCC's questions.

Second, these arguments fail to appreciate the likely impact of disaggregation of the existing generation portfolios and the importance of co-insurance in managing the impact on contract markets that may otherwise result.[13]

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[9] NSW Government Submission, Part A, section 4.1
[10] *Re 7-Eleven* (1994) ATPR 41-357 at 42,677; *Re Qantas Airways Limited* [2004] ACompT 9 at [164]-[189]
[11] *Re Qantas Airways Limited* [2004] ACompT 9 at [180]
[12] See further NSW Government, "New South Wales Energy Reform Strategy: Delivering the Strategy: approach to transactions and market structure", pp8-10
[13] See further NSW Government Submission, Part C, sections 1, 4 and 6.1.

Finally, for the reasons set out in the Submission, there are limitations and issues associated with the potential alternatives to co-insurance.[14] Not only are those alternatives limited in their ability to achieve the firm capacity provided by co-insurance to participating Gentraders, those alternatives will not enable the Government to meet all of its objectives of the Energy Reform Strategy including, in particular, the Government's value objectives and the objective of ensuring new entry. The Government refers to the Submission.[15]

New entrants

Snowy Hydro and TRUenergy question the importance of co-insurance to encouraging new entry. 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).[16] 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.

Benefits to Gentraders

All of the interested parties have submitted that the benefits of co-insurance will vary across the participating Gentraders due to differences in the reliability and other features of the underlying generation assets. These submissions should not be accepted as their underlying assumption is not correct. The co-insurance arrangement will take into account differences between the underlying generation assets in setting the level of firm capacity applying to each Gentrader.

In addition, the design of the calling rules through the surplus/deficit order will mean that those Gentraders which call on co-insurance the most will be more often called upon than those that do not call upon co-insurance.[17]

Further, it is also important to note that it is up to a Gentrader as to whether or not it calls on co-insurance. There is no requirement for a Gentrader to call on co-insurance. Given that calling on co-insurance means that a Gentrader is more likely to be called, Gentraders may decide not to call on co-insurance. Regardless of whether Gentraders decide to call on co-insurance, it remains open to Gentraders to negotiate other arrangements to firm-up capacity available under the Gentrader contracts. These other arrangements can work alongside, or in addition to, the co-insurance arrangement.

Conditions suggested by interested parties

Duration

The interested parties have raised concerns about the proposed 10 year duration and suggest that it be limited to a short time frame. The Government refers to section 7 of Part C of the Submission which addresses the appropriateness of the 10 year duration.

Limitation of co-insurance within existing portfolios

Snowy Hydro has suggested that co-insurance, if authorised, should be limited to arrangements within the existing businesses. This suggestion ignores the benefits that will flow by reason of there being a broader portfolio of power stations participating in the co-insurance arrangement, which would be compromised by such a limitation.

[14] NSW Government Submission, Part C, section 6.2.
[15] NSW Government Submission, Part C, section 6.2.
[16] See further NSW Government Submission, Part C, section 3.2
[17] See further NSW Government Submission, Appendix 1, section 2.2.