New South Wales Government

ENERGY REFORM STRATEGY

Response to issues raised in a meeting with the ACCC in relation to the co-insurance arrangement for the Energy Reform Strategy

Response to ACCC's issues for discussion

19 MARCH 2010

On 4 March 2010, representatives from the ACCC met with staff from NSW Treasury, Baker & McKenzie and Frontier Economics to discuss issues in relation to co-insurance. This note provides a response to the issues raised by the ACCC.

Term of the proposed co-insurance arrangement

The duration of the co-insurance arrangements is discussed in the NSW Government's submission.[1] The NSW Government believes that a term of 10 years for the co-insurance arrangements is important in order for the arrangements to provide the public benefits set out in the NSW Government's submission.

Further to the discussion set out in the submission, and in response to other submissions put to the ACCC, the NSW Government makes the following observations in regard to the term of the co-insurance arrangement.

First, the need to manage outage risks is of particular importance at the current time and for the near future, both in NSW and across the NEM more widely, because of the tightening of the generation supply/demand balance. This is very different from when NSW first embarked on reforms in the early 1990's and from when Victoria embarked on their reforms in the 1990's. When the NSW Government first disaggregated the vertically and horizontally integrated monopoly, Pacific Power, the Reserve Plant Margin (RPM) exceeded 35%, with an average capacity factor of only 55%.[2] With this level of idle capacity it was little trouble for the three new generation businesses (Macquarie Generation, Delta and Eraring) to manage their risk of outages. By contrast, the 2009 Electricity Statement of Opportunities (ESOO) indicates that the RPM is expected to be around 15%.[3] With such a tight supply/demand balance it is difficult for five smaller GenTraders to manage the risk of outages.

The tight supply/demand balance will also have implications for the retail market. The benefits of co-insurance in the retail market are discussed in the NSW Government's submission.[4]

Second, the efficiencies of the co-insurance arrangements arise from the extent to which the arrangements support new entrants – both generators and, through their entry, new retailers. As already outlined in the NSW Government's submission,[5] new entrant

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1 NSW Government, *Submission in support of application for authorisation in relation to the co-insurance arrangement for the Energy Reform Strategy*, lodged by the Treasurer, the Hon. Eric Roozendaal MLC, on behalf of Delta Electricity, Eraring Energy and Macquarie Generation. See Section 7 of Part B.

2 Electricity Supply Association of Australia (1993), Measuring the Efficiency of the Australian Electricity Supply Industry, p56.

3 Australian Energy Markets Operator (2009), Electricity Statement of Opportunities for the National Electricity Market – Supply/Demand Balance Calculator.

4 Sections 3.2 and 4 of Part C.

5 Sections 3.2 and 7 of Part C.

generators will not place much value on a co-insurance arrangement that only survives for a few years. The reasons for this are clear. The co-insurance arrangement needs to support the new entrants long enough to allow them to make investments in the market and for those investments to operate in the market for a sustainable period. The 2009 ESOO indicates that NSW requires additional capacity from 2014/15, and every year thereafter.[6] This means that if the co-insurance arrangement was 5 years or less, then it would not be effective in supporting new generation investment by a new entrant.[7] If the co-insurance arrangement continued the full term that the NSW Government has proposed (10 years), it would provide a maximum of 5 years of support for any investment expected in NSW. The NSW Government therefore contends that the 10 year term of the co-insurance arrangement is critical in supporting its policy aims of maximising the opportunities for new entrants, particularly in the context of the tight balance of supply and demand.

As discussed in the NSW Government's submission,[8] alternatives to co-insurance are unlikely to support new entry in the same way. While there are other ways that new entrants can manage the risk of outage associated with a small portfolio of generation assets, these are unlikely to be as effective as co-insurance at facilitating new entry and investment. First, as discussed in the NSW Government's submission,[9] it will be difficult for Gentraders to negotiate equivalent risk mitigation arrangements following the completion of the transaction. Second, existing forms of insurance (including existing financial contracts) are principally short term products. Particularly in the current market, with significant uncertainty about the design and implementation of the CPRS, new entrants would find it difficult to find long-term products to help manage outage risk.

Extent to which the co-insurance arrangement will be utilised

The extent to which the co-insurance arrangements are utilised will ultimately depend on the commercial incentives of Gentraders that are party to co-insurance arrangement.

As discussed in the NSW Government's submission,[10] Gentraders are able to call upon co-insurance whenever the available capacity from their Generator drops below the co-insurance firm capacity. The extent to which co-insurance will be utilised therefore depends on two things:

- **The level of firm capacity under co-insurance**. The higher the level of firm capacity that a Gentrader receives under co-insurance, the more likely that the

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6 AEMO (2009), op cit p2-9

7 It is important that the co-insurance arrangements are put in place immediately to support a new entrant generators ability to sell as many firm hedges as possible. This will assist the new entrant secure financing terms competitive with incumbent portfolio generation, all other things being equal.

8 Sections 2.2 and 6.2 of Part C.

9 Section 6.2 of Part C.

10 Section 3 of Part B, and Appendix 1.

available capacity from their Generator will fall below firm capacity. The setting of the level of firm capacity is discussed in the NSW Government submission.[11]

- **The extent to which Gentraders choose to call co-insurance**. Gentraders that are eligible to call co-insurance may choose not to call co-insurance. Gentraders may choose not to call co-insurance for a number of reasons:
    - because the co-insurance price is higher than the Gentrader's expectation of the spot market price (in which case the net cashflow to the calling Gentrader under co-insurance would be negative);
    - because the Gentrader can access some other cheaper form of insurance; or
    - because the Gentrader wants to reduce the likelihood that they are called on to supply co-insurance.

While Gentraders that are eligible for co-insurance can choose whether or not to call co-insurance, Gentraders that are called on to supply co-insurance cannot choose whether or not to supply co-insurance.[12] As discussed in the submission, Gentraders that are called on to supply co-insurance are obliged to supply that co-insurance (i.e. to make the required co-insurance payments) if they have available capacity above their own co-insured firm quantity.

Because the calling Gentrader but not the supplying Gentrader has the option to trigger co-insurance payments, Gentraders cannot unilaterally opt out of the co-insurance scheme. A Gentrader can decide never to call on co-insurance. Due to the operation of the surplus-deficit order, this will reduce the likelihood of that Gentrader being called on to supply co-insurance. However, the Gentrader will remain liable to supply co-insurance in certain circumstances.

Operation of the co-insurance allocation rules, particularly in the initial period

The surplus-deficit order is designed to ensure that the Gentrader that has called on co-insurance the most is the first to supply co-insurance in the event of co-insurance being called. The surplus-deficit order is discussed in the NSW Government's submission.[13]

In the initial period following the commencement of the co-insurance arrangement, the allocation of co-insurance will depend on the initial ordering of Gentraders under the surplus-deficit order. At the commencement of the co-insurance arrangements, each Gentrader will be allocated a value under the surplus-deficit order, which will result in an initial ranking of Gentraders to determine the Gentrader that is first called on to supply co-insurance. The initial value for each Gentrader under the surplus-deficit order is likely to be based on the expected availability of each power station, so that the Gentrader considered most likely to call on co-insurance (due to the lower reliability of its power station) is ranked first in the initial surplus-deficit order and will be the first to be called on to supply co-insurance.

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11 Section 3.5 of Part B, and Section 3 of Appendix 1.

12 Section 3 of Part B, and Section 2 of Appendix 1.

13 Section 3.9 of Part B, and Section 2.2 of Appendix 1.

Definition of the ‘super majority’ required to terminate the arrangement

While individual Gentraders cannot opt out of co-insurance (but can lower the likelihood that they will be called on to supply co-insurance by not themselves calling on co-insurance) Gentraders can terminate the co-insurance arrangement under a super-majority vote.

The intention of requiring a super-majority vote to terminate co-insurance, rather than a simple majority vote, is to provide bidders, particularly new entrant bidders, with some confidence that the co-insurance arrangement cannot be terminated by block voting of larger incumbents. Clearly, though, it is also undesirable for the super-majority vote to result in a single Gentrader being able to deny all other Gentraders the opportunity to terminate co-insurance. The voting rules will attempt to balance these competing objectives.

Each Gentrader’s vote under the super-majority rule is likely to have regard to the capacity of each Gentrader (either contract capacity under the Gentrader contracts or the firm capacity under the co-insurance arrangements) and/or the expected availability of each Gentrader.