LOY YANG
Marketing Management Company

14 April 2010

General Manager
Adjudication Branch
Australian Competition and Consumer Commission
GPO Box 3131
CANBERRA 2601

By email: adjudication@accc.gov.au

Dear Sir/Madam,

RE: SUBMISSION IN RESPONSE TO ACCC DRAFT DETERMINATION OF 25 MARCH 2010 - MACQUARIE GENERATION & ORS – APPLICATION FOR AUTHORISATION - A91198 & A91199

Loy Yang Marketing Management Company Pty Ltd (LYMMCo) welcomes the opportunity to make a submission in response to the Australian Competition and Consumer Commission's (ACCC) Draft Determination concerning the proposed co-insurance arrangement between electricity generators and gentraders in New South Wales.

LYMMCo endorses the findings of the ACCC in the Draft Determination and is of the view that the New South Wales Energy Reform Strategy should not be considered dependant on the proposed co-insurance arrangement.

Introduction

LYMMCo operates as the arm's length agent for Loy Yang Power, performing the energy trading functions and managing National Electricity Market regulatory and market development activities for Loy Yang Power.

Loy Yang Power is the largest single privately-owned generator in the National Electricity Market (operating the Loy Yang A power station) and the supplier of coal to both the Loy Yang A and Loy Yang B stations.

In total, LYMMCo trades in excess of 2,200 MW which represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia.

Given the characteristics of the relationship between LYMMCo and Loy Yang Power, including the separate ownership structures, LYMMCo is ideally placed to comment on the issues raised in the ACCC's Draft Determination.

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Discussion

The ACCC provides that:

> *The essential feature of the gentrader model is that it creates a functional separation between ownership of the generation asset . . . and the ownership of the contractual rights to trade the capacity of the generation asset . . .*[1]

The New South Wales Energy Reform Strategy provides that gentraders will have control over bidding strategy; the dispatch of energy produced by generators into the NEM, hedging strategies and by implication the use of other practices available to manage risk.

In this regard, the gentrader model has some similarities with the relationship between LYMMCo and Loy Yang Power where LYMMCo deals with market operations (physical and forward) and related concerns whilst Loy Yang Power is responsible for the operation and maintenance of the Loy Yang A power station and the sourcing of fuel.

In both circumstances, the decisions by one party have direct impacts on the business of another and those inter-relationships give rise to specific risks.

Risk of unfunded difference payments

The ACCC notes that the co-insurance proposal manages the risk of unfunded difference payments. A risk faced by market participants broadly and LYMMCo in particular.

As a single location entity, LYMMCo does not benefit from any natural hedge available to participants with a portfolio of assets. Therefore, LYMMCo trading strategies and risk management policies are highly sensitive to unmanaged exposure to contract payments that are not offset by pool earnings by unique generating units. This exposure can arise in two broad ways: (1) plant failure; and (2) transmission risk.

Plant failure is best managed by the owners (or operators) of the plant. In LYMMCo's circumstance, it does not operate, manage or maintain the plant which generates the energy it trades. Therefore, it is critical that maintenance arrangements are in place that minimise risk of plant outage especially during periods where contract positions could potentially expose LYMMCo to unfunded difference payments.

While the carriage of risk between LYMMCo and Loy Yang Power differs to that proposed for gentraders; there are parallels in the way plant risk will need to be managed between the various entities. Hence, we do not believe co-insurance is the mechanism required to manage plant outages. Rather this risk is best managed through well developed maintenance plans, outage schedules and prudent trading positions governed by a robust risk management regime. We also support the ACCC proposition that co-insurance may weaken incentives to appropriately manage plant risk.

Transmission risk, which could be transmission failure or congestion leading to a generator being constrained off, is more difficult to manage. This is because of the nature of the risk (which is nearly always beyond the control of the power station or its trading arm) and that the range of risk management tools is also very limited if not unviable in some circumstances.

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[1] Australian Competition and Consumer Commission, Draft Determination, Macquarie Generation & Ors – Application for Authorisation - A91198 & A91199, 25 March 2010, p.i

Transmission risk does produce incentives for parties to reduce their contracted positions and increase their pool exposure so as to minimise the risk of unfunded difference payments. While this may reduce, in the short-term, available contracts from a unique generator it does not necessarily suggest a reduction in competition or market incentives overall.

A short-term reduction in available contracts from specific market participants, like gentraders, could lead to a number of outcomes, for example: an increase in price to offset risk which induces additional contracts from at risk generators/gentraders; new entry due to contract demand and/or price; release of contracts held by retailers to capture increased price/risk trade-offs; and/or sourcing of non-contractual hedges (i.e. physical cover) by traditional purchasers of wholesale contracts.

This is not to suggest it is appropriate for generators or gentraders to bear transmission risk in all its current forms. Rather, that credible transmission failure is manageable by the market and any reductions in contracted availability will be offset by the market overall. Therefore, co-insurance is not a necessary requirement to manage credible transmission risk although it may be advantageous to gentraders (but must be subject to general competition criteria).

Alternatively, in the circumstance of low probability, high-impact (catastrophic) failures, which would lead to a generator being constrained off for extended periods of time or during high-priced events, the risk of financial failure can not be effectively offset in the current market. This is one of LYMMCo's concerns with current market arrangements and we suggest a flaw in the market's design. However, we are not convinced that co-insurance would cater to these types of events or provide a public benefit.

Therefore, the risk of financial failure due to catastrophic transmission failure will not be mitigated or at best could only be partially mitigated by the proposed co-insurance scheme. We believe this issue is best resolved by a targeted review of transmission services which should be conducted by the Australian Energy Market Commission or similar.

Benefit to a new entrant of co-insurance

We question any argument that a new entrant would be unable to acquire one of the gentrader portfolios in the absence of co-insurance arrangements. The position of a new entrant, compared with incumbents, may be unique; however, a new entrant needs to be financially and operationally capable of operating a gentrader.

If anything, these concerns raise questions about the policy requiring at least one new entrant rather than on the need for co-insurance. LYMMCo does not have a view on the appropriateness of that policy and supports new entry in broad terms; however, we suggest the risks posed to competent new entrants would be similar to the risk exposure of a range of existing market participants and therefore does not warrant special treatment in the form of co-insurance.

The application also fails to consider that the new entrant may prefer alternative risk management arrangements in place of co-insurance. Therefore, locking future acquirers of gentraders into arrangements which they may not desire and may not be able to end independently of other parties may be ill-conceived.

Use of alternative risk management tools

LYMMCo supports the position that gentraders have a range of products available to manage the risk of unfunded difference payments in the absence of catastrophic transmission failure; these products include:

- unit outage insurance products;
- the development of complementary generation assets;
- service relationships with third parties;
- alternative hedging strategies;
- business interruption insurance;
- self-insurance; and
- trading products (electricity, weather derivatives, etc).

Therefore, we do not consider the co-insurance arrangements as a necessary pre-condition for the New South Wales Energy Reform Strategy to proceed.

Public benefit

The public benefits attributed to the proposed co-insurance scheme:

- encouraging new entry and thereby greater competition in the New South Wales generation sector;
- improved wholesale level outcomes;
- improved retail level outcomes; and
- value enhancement and cost savings for the New South Wales Government.[2]

We question any conclusions which suggest the co-insurance proposal encourages new entry. An appropriate perspective is that the co-insurance arrangement limits future flexibility for new entrants. The absence of a broader push for insurance arrangements over the course of the market's history suggests it is not in the broader interests of market participants to rely on co-insurance. This is despite the perceived marginal benefits in the period immediately following commencement of a gentrader.

We are not convinced that wholesale market outcomes will improve as a consequence of co-insurance arrangements and suggest co-insurance may have distortionary impacts on the market. We endorse the ACCC's findings in this regard.

We do however, question the view the ACCC appears to have arrived at that a greater level of firm contract capacity being available than otherwise would be the case without co-insurance represents the measure of public benefit.[3] While we share the views expressed by TRUenergy that co-insurance may in effect work counter to the applicant's claims on wholesale market outcomes, even if that was not the case, the wholesale market is a mature and functioning market with readily available contracts at competitive prices. The evidence to support a view that the New South Wales Energy Reform Strategy will undermine the market in the absence of co-insurance is not compelling.

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[2] Australian Competition and Consumer Commission, Draft Determination, Macquarie Generation & Ors – Application for Authorisation - A91198 & A91199, 25 March 2010, p.27-28

[3] Australian Competition and Consumer Commission, Draft Determination, Macquarie Generation & Ors – Application for Authorisation - A91198 & A91199, 25 March 2010, p.28

While we believe the absence of co-insurance would not have a negligible impact on wholesale markets, even were reduced contract capacity to eventuate, existing market participants and gentraders would be responsive to those opportunities to ensure demand for contracts would be satisfied. Therefore, we do not believe any overall public benefit could be identified even if the impact on future acquirers of gentraders of the co-insurance scheme was to increase contracted capacity.

We concur with the ACCC's findings in relation to value enhancement for the New South Wales Government and note the public detriment implications of the proposal.

Scheme inequity arises due to discrete private benefits

LYMMCo endorses the ACCC's findings concerning the absence of notable public benefits and the likely distortionary implications of the co-insurance scheme. While LYMMCo does not believe the co-insurance scheme is a necessary risk management tool for the future acquirers of gentraders, we do note that there is likely to be a private benefit derived by the relevant gentraders through the use of this additional risk management arrangement.

In this regard, our final concern relates to the selective application of the co-insurance scheme. LYMMCo is not advocating a universal or market wide opt-in scheme; however, should co-insurance schemes be considered a worthwhile risk management arrangement going forward, they would need to be open to all market participants so as to not advantage a select group and disadvantage the wider market. We are not convinced such a scheme or schemes, which may satisfy concerns regarding competitive neutrality if available widely, would be economically efficient, practical or in the public interest. Hence, our opposition to the proposed co-insurance scheme remains.

Conclusion

LYMMCo supports the ACCC's proposal to deny authorisation to Macquarie Generation, Delta Electricity, Eraring Energy and the future acquirers of the gentrader portfolios to make and give effect to the proposed co-insurance arrangement.

If you have queries in relation to this submission please do not hesitate to contact me on, telephone, (03) 9612 2236 or via email: jamie_lowe@lymmco.com.au.

Yours sincerely,

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