New South Wales Government

ENERGY REFORM STRATEGY

Response to third party submissions on ACCC draft determination in relation to the co-insurance arrangement for the Energy Reform Strategy

Response to industry submissions on ACCC draft determination

Introduction

Following the ACCC's draft determination of 25 March 2010 on the NSW Government's application for authorisation of the co-insurance arrangement, submissions were made to the ACCC by several industry participants and stakeholders, namely:

- TRUenergy
- The Loy Yang Marketing Management Company (LYMMCO)
- ERM Power Pty Ltd (ERM)
- Victoria Electricity, on behalf of the Infratil Group (Infratil)
- The Major Energy Users Inc (MEU)

All of these submissions, with the exception of ERM's submission, are critical of the proposed co-insurance arrangement and are therefore supportive of the ACCC's draft determination not to authorise the co-insurance arrangement. The ACCC has provided the NSW Government with the opportunity to comment on these submissions. While the NSW Government's substantive arguments in support of its co-insurance proposal can be found in the NSW Government's submission in response to the draft determination[1], the NSW Government is pleased to take this opportunity to further explain the value of its proposal and address a number of misconceptions that feature prominently in the submissions regarding the rationale for the scheme and its operation and consequences.

The function and economic efficiency of co-insurance

The public policy objectives

The public policy objectives of the proposed co-insurance arrangement were discussed in detail in the NSW Government's initial submission and in its response to the ACCC's draft determination.

In brief, the NSW Government seeks to secure public policy benefits through increased competition by disaggregating existing generation portfolios. However the process of disaggregation affects the ability of owners of these generation

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[1] Lodged on 19 April 2010

assets to self-insure against outage risks. Without viable alternatives to manage this risk, Gentraders are likely to reduce the supply of firm contracts offered to the market. This will have negative effects on retail competition, principally by reducing the scope for independent entry and expansion. In an environment of a tightening supply demand balance, this is likely to increase the cost of firm contracts for retailers and ultimately end users of electricity. It can also jeopardise the primary objective sought by disaggregation – increased competition at the wholesale level – because new entrants will find it especially difficult to access mechanisms to manage the outage risks associated with the NSW assets on competitive terms. This is consistent with the views of ERM.[2]

It is the NSW Government's view that co-insurance is required for the successful implementation of the Gentrader model, as proposed by the NSW Government, including the disaggregation of the generation portfolios into five bundles, and a requirement for new entry. This will avoid a significant reduction in firm contracting that would otherwise result in the absence of co-insurance. As set out in its response to the ACCC's draft determination, the NSW Government considers that the counterfactual must take into account the likely changes to the Energy Reform Strategy that would be made by the NSW Government in the event that the ACCC denies authorisation for co-insurance. The NSW Government therefore disagrees with the view of the MEU that it is appropriate to delink the proposed Energy Reform Strategy from the co-insurance arrangement.[3]

Empirical findings

A key issue – as identified by both the ACCC and TRUenergy – is whether co-insurance:

- is a more effective and efficient way (i.e. reduces risk at lower cost) of managing outage risks, given the characteristics of the NSW assets; and
- would result in greater levels of firm capacity being available.

This is an empirical question. The NSW Government in its response to the ACCC's draft determination provided empirical modelling which shows that co-insurance outperforms alternative methods of managing outage risk (namely alternative contractual mechanisms and the physical ownership of generation plant) by 14-24% (as measured by the reduction in risk for any given return). This saving translates into a public efficiency gain because in competitive wholesale and retail markets, all else being equal, it will translate into a higher level of firm contracting.

The NSW Government notes that none of the submissions provide any data or evidence that would contradict or undermine this finding. TRUenergy and LYMMCO assert that there are a range of options for managing outage risk.

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2 ERM submission, p 1.

3 MEU submission, p 9.

However, the submissions do not provide any evidence that these alternatives are likely to be more effective and efficient than the co-insurance arrangement.

As explained by the NSW Government in both its initial submission and subsequent response to the ACCC, and by ERM in its submission,[4] alternative options including voluntary multi-lateral arrangements between generators, contractual mechanisms (such as traded derivatives and other insurance-type products) and the physical ownership of generation plant are either not available in the market or are available at a cost that would not allow Gentraders, particularly new entrants, to effectively compete in the wholesale market.

Importantly, given the incentives of existing generators in the NEM, the NSW Government considers it unlikely that more effective and efficient means of managing this risk will emerge in NSW over the coming period. This is particularly the case for new entrants who are unlikely to be in a strong position, relative to incumbent generators, in any bi-lateral negotiation to develop financial arrangements following the completion of the transactions. This is consistent with the views of ERM.[5]

For this reason, the NSW Government disagrees with LYMMCO's assessment that the absence of voluntary arrangements in the NEM suggests that it is not in the broader interests of market participants, including new entrants, to rely on co-insurance, and that co-insurance does not encourage new entry.[6] Rather, the absence of voluntary arrangements is likely to be the result of coordination failure between private parties attempting to establish co-insurance arrangements, the interest individual participants have to selectively opt-out of any scheme[7] and the lack of interest incumbent generators are likely to have in encouraging new entry. In this respect the NSW Government strongly disagrees with LYMMCO's assessment that the co-insurance arrangement is not required to support new entry.[8]

Response to specific points raised by submissions

The rationale for co-insurance

There appears to be a considerable level of misunderstanding as to the outcomes sought by co-insurance and thus its advantages in the eyes of the NSW Government. The MEU suggest that co-insurance is a necessary consequence of the NSW Government's adoption of the Gentrader model (as opposed to an

4 ERM submission, p 1.

5 ERM submission, p 1.

6 LYMMCO submission, p 4.

7 This arises because any one party could secure benefits from such arrangements if it was to defect from the arrangement and the other parties went ahead.

8 The role of co-insurance arrangements in supporting new entry is addressed in greater depth in section 4.3.2 of the NSW Government's response to the ACCC's draft determination.

outright divestment of energy assets).[9] The notion that co-insurance follows from the implementation of the Gentrader model is also implicit in the submissions by LYMMCO and Infratil.

It is important to note that the implementation of co-insurance arrangement is not fundamentally a function of a switch from a divestment model to a Gentrader model. Rather, it is a consequence of the physical disaggregation of generation assets that is part of the Energy Reform Strategy. It is this disaggregation that increases outage risk, and this would occur regardless of whether reform progressed along the lines of a "standard" divestment model or the Gentrader model.

The co-insurance arrangement does support the Gentrader model[10] and the Gentrader model does have some implications for the design of the co-insurance arrangement, but that model does not in and of itself have a bearing on the underlying rationale for co-insurance.

Co-insurance and risk management

Co-insurance is required for the implementation of the Gentrader model, as proposed by the NSW Government, including the disaggregation of the generation portfolios into five bundles, and a requirement for new entry, to avoid the significant reduction in firm contracting that would result in the absence of co-insurance. The MEU state that the co-insurance arrangement is a mechanism to transfer the outage risk associated with the power stations from the Gentraders to consumers such that the "the cost of the co-insurance is carried by electricity consumers."[11] The NSW Government strongly disagrees with this view. As stated in both its initial submission and subsequent response to the ACCC, co-insurance is a means of managing the significant outage risk resulting from the disaggregation of generation portfolios by pooling these Gentrader risks amongst scheme participants. Co-insurance does not seek to manage Gentrader's risks by transferring those risks to other parties, but to manage those risks through insurance at the Gentrader level.

In a competitive wholesale and retail market, the cost of managing outage risk will be reflected in retail prices paid by end-users. As demonstrated by the evidence provided by the NSW Government to the ACCC, co-insurance is able to manage outage risk more effectively and efficiently than the alternative options. Therefore, in contrast to the MEU's concerns, the proposed co-insurance arrangement will provide for a better management of this risk, and a higher level of firm contracting. Ultimately, this will result in lower prices for retail customers, including large energy users. This is consistent with the views of ERM who note that with limited alternative options to managing this risk, in the

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9 MEU submission, p 5.

10 As set out in the NSW Government's initial submission, co-insurance is an important element of the Gentrader model as it provides Gentraders with a higher level of firm capacity than they would otherwise have under the Gentrader contracts alone.

11 MEU submission, p 6.

absence of co-insurance, a lower level of firm capacity will be offered to the market with negative impacts for retail customers.[12]

Co-insurance and new investment

In contrast to the MEU's concern, the co-insurance scheme does not provide a disincentive to build new generation.[13] It does however avoid the need for inefficient investment in capacity, or a socially wasteful allocation of resources. One of the central objectives of the Energy Reform Strategy is to create incentives for socially efficient investment in generation capacity and to ensure retail prices for end use customers reflect the efficient cost of supplying electricity, including efficient management of outage risk. It is important to note that alternative options such as investing in physical plant come at a significant cost. Investing in physical plant to provide a self-insuring portfolio is an extremely costly option for managing outage risk. As outlined in its response to the ACCC's draft determination, the NSW Government does not accept the ACCC's view, as well as the view of a number of industry stakeholders, that in the short to medium term, investing in physical plant is a more effective and cost efficient response to managing outage risk than the co-insurance arrangement. Based on its modelling results, the NSW Government considers that, relative to investing in physical plant, co-insurance is likely to facilitate more efficient generation investment decisions than would otherwise be the case. This is likely to provide benefits for small and large end use electricity customers.

Co-insurance and competition

Many of the criticisms made by Infratil reflect broader reservations that Infratil has with the Gentrader model itself, rather than co-insurance per se. Since the issue before the ACCC is the public benefits of co-insurance, the NSW Government will not, on this occasion, address in detail these broader claims.

However, the NSW Government observes that one of the main issues raised by Infratil is the extent to which the Gentrader model promotes competition: both competition in the wholesale market (i.e. the trading capacity) and competition for the market (in the sense of allowing for parties to access the rights to trade capacity). It should be evident that the NSW Government's co-insurance proposal is very much attuned to these concerns. As already observed, the co-insurance arrangement is an integral part of deepening competition in the market, because it allows the Government to pursue disaggregation while managing the resulting increase in outage risks. The co-insurance will also deepen competition for the market by facilitating new entry, given the difficulties that new entrants would otherwise experience in accessing mechanisms to manage outage risks.

Public detriment

The submissions by TRUenergy, LYMMCO, and MEU also suggest various detriments will arise from the implementation of co-insurance arrangement. For

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12 ERM submission, p 1.

13 MEU submission, p 8.

the most part, these claims have already been addressed by the NSW Government in its response to the ACCC's draft determination. In brief:

- The NSW Government agrees with the ACCC's findings that the co-insurance arrangement is designed to safeguard against co-ordinated bidding. However TRUenergy alleges that by enabling parties to calculate how much capacity needs to be set aside to meet co-insurance calls, incentives for, as TRUenergy describe it, "pool price maximising behaviour" will increase. This ignores the fact that in the absence of co-insurance, parties will typically seek to use self-insurance as one means of managing outage (and thus pool price) risk by contracting to a lower level of capacity. If parties are able to estimate the amount of capacity needed by others to meet co-insurance calls, they will also be able to estimate how much capacity is needed for self-insurance purposes.

- The NSW Government rejects the notion that the co-insurance arrangement will cause material distortions to the market for risk management products. As stated previously, alternative options are either not available in the market or not available at a cost that would allow Gentraders, particularly new entrants, to effectively compete in the wholesale market. However, co-insurance does not eliminate nor prevent Gentraders from seeking alternative strategies to manage outage risk if products become available that allow Gentraders to manage this risk at a cost that enables them to effectively compete in the wholesale market. If a Gentrader considers that the co-insurance price is higher than the Gentrader's expectation of the spot market price, or the Gentrader can access some other cheaper form of insurance and wants to reduce the likelihood that it is called on to supply co-insurance, then a Gentrader can decide not to call on co-insurance and manage its risk through alternative means. For these reasons the NSW Government does not consider that the co-insurance arrangement has any material effect on the market for risk management products by foreclosing some opportunities for other providers.

- The NSW Government rejects the argument that parties outside the co-insurance arrangement would be at a disadvantage because of their exclusion from the arrangement. The policy rationale for co-insurance lies in the need to manage the change in outage risks created by disaggregation of the NSW generation assets, and in order to avoid undesirable public policy outcomes that would result from this change. Parties that do not acquire NSW Gentrader rights are by construction not part of the co-insurance arrangement. These parties will have open to them the range of alternative arrangements for managing outage risk. Most likely, parties that invest in new capacity in NSW will manage outage risk as part of an existing portfolio of assets.

- LYMMCO notes that the NSW Government has not considered that the new entrant Gentrader may prefer alternative risk management arrangements in place of co-insurance. As observed by the NSW

Government in both its initial submission and subsequent response to the ACCC, co-insurance does not eliminate the need for Gentraders to seek alternative strategies to manage outage risk and certainly does not prevent Gentraders from seeking out alternative strategies if they provide a more effective and efficient means of managing risk. If the Gentraders do not consider there to be sufficient benefit, such that they could be better off with alternative means of managing this risk, then they can choose to dissolve the arrangement.

- The NSW Government rejects the notion that the co-insurance arrangement reduces the incentives for generators to maintain reliability. In contrast to the MEU's concerns,[14] reducing the NSW Government's exposure to this risk does not mean that any individual generator is necessarily less exposed to this risk. Not only is an individual generator still exposed to this market risk under the co-insurance arrangement, it may also be required to pay damages under the Gentrader contract to the extent that it is not able to meet its availability targets set out in the contract.

- The NSW Government rejects the notion that the co-insurance arrangement creates public detriment by adversely affecting bidding behaviour and the market for non-firm contracts. The MEU raises concerns over the extent to which the co-insurance will create incentives for Gentraders to bid strategically to maximise revenue.[15] The NSW Government has previously stated that the Gentraders will face the same incentives as generators currently do to maximise revenue. In addition, as outlined in its response to the ACCC's submission, the NSW Government does not accept that there will be any public detriment created through some alleged impact on the 'market' for non-firm contracts. Even in the absence of co-insurance both Gentraders and retailers are unlikely to value non-firm contracts given that they are not an effective risk management instrument. Generators and retailers rarely enter into non-firm contracts.

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14 MEU submission, p 22.

15 MEU submission, p 22.