TRU energy

13 January 2010

Your ref: 39819

The General Manger
Adjudication Branch
Australian Competition and Consumer Commission
GPO Box 3131
Canberra ACT 2601

Via Gavin Jones
Director, Adjudication Branch

By email: adjudication@accc.gov.au

Dear Mr Jones,

Applications for Authorisation A91198-A91199 lodged by the NSW Treasurer for and on behalf of Macquarie Generation, Delta Electricity and Eraring Energy (the Applicants) in relation to the co-insurance arrangement for the NSW Energy Reform Strategy (ERS) (Applications)

TRUenergy is a significant private sector participant in the National Electricity Market (**NEM**), acting as both retailer and generator. This includes our ownership of the 430MW Tallawarra power station in New South Wales. TRUenergy has an interest in the outcome of the determination on the Applications, both as a participant in the NEM and as a potential acquirer of retail and new or established generation sites as part of the ERS privatisation process. This response is provided for use by the Australian Competition and Consumer Commission (the **ACCC**) in assessing the Applications.

TRUenergy considers that the co-insurance scheme proposed in the Applications does not achieve the public benefit requirements necessary to be granted an authorisation under Section 88(1A) of the Trade Practices Act. Specifically, we are of the view that the proposed co-insurance scheme represents a significant and ongoing anti-competitive distortion to the market which would not result in a benefit to the public that outweighs the detriment to the public interest. This assessment is underpinned by the view that the proposed co-insurance arrangement would not promote market efficiency within the NSW electricity market, or more broadly within the NEM.

Our key concerns with the proposed scheme include:

- A core objective of the proposal relates to increasing sale value of the Gentrader contracts, rather than enhancing the public benefit more generally and in a continuing sense. As outlined in more detail below, we do not accept that increased NSW taxpayer revenue satisfies the broader public benefit test set out in the Trade Practices Act– particularly given the impacts on neighbouring NEM regions that this proposal would have.

- Experience in the NEM to date indicates that the market is capable of managing firmness risk and that centralised co-insurance is not required. A wide variety of mechanisms are available to manage these risks that will be effectively excluded if the proposed co-insurance scheme is locked in for 10 years as proposed. In many instances these mechanisms would be more efficient than the proposed co-insurance scheme and, therefore, deliver enhanced public benefits. Relevant experience and alternatives include:

  - Victorian Generator Privatisation – While an initial centralised co-insurance scheme was implemented for this sale, it was subsequently disallowed by the ACCC. After withdrawal of the scheme market participants successfully innovated to manage firmness risk in a variety of ways.

  - Sale of non-firm swaps – Retailers may be willing to purchase a portion of non-firm contracts from Gentraders and manage them using their own broader portfolios. Given that many of the likely buyers of the NSW retailers are existing NEM participants, the ability to bring wider NEM portfolios into play in firming up NSW cover is realistic and likely to be more efficient than a one size fits all co-insurance proposal.

  - Use of outage insurance – Insurance markets have for many years provided an external source of risk capital in the form of forced outage cover for NEM Generators. Generator to Generator derivative outage cover instruments are also available in the NEM. All of these options have the potential to be more efficient than the co-insurance proposal.

- A further concern with the proposal is that is does not allow all generators to participate, leaving non-coal generators including new entrants outside its scope. This exclusive element of the proposal could leave generators outside the scheme (including generators yet to be constructed) with an informational disadvantage compared to scheme participants.

- Finally, the co-insurance scheme design provides information to Gentraders that undermines the normal competitive market in high demand conditions when no plant outages occur. Knowledge that Gentraders are unlikely to contract non-firm capacity (because it could be required to back co-insurance calls) will increase incentives for pool price maximising behaviour in NSW. This outcome is comparable with the existing ETEF scheme which creates similar information anomalies that drive high pool price outcomes in NSW. Extension of such a scheme into a privatised NSW marketplace would be incompatible with public benefit.

While we do not support the implementation of the co-insurance proposal in any form, we would suggest that if the ACCC is minded to allow the scheme to proceed, it should be for a minimum transition period of no longer than one year. Locking the scheme in for 10 years would be likely to result in significant detriment to the public good, compared to outcomes that a competitive market could deliver.

In the attached paper we have responded to each of the key benefits claimed by the Applicants in Part C of the Applicants' Submission and to the arguments of the Applicants that there are negligible anti-competitive detriments associated with the proposed scheme. For ease of reference we have indicated the relevant sections of the Submission to which we are responding.

Please contact Mark Frewin or myself (via 8628 1000) to discuss this submission in more detail.

Yours sincerely

Carlo Botto
Director Portfolio Management

Response to Part C of Applicants' Submission

1. Co-insurance is a key element of the energy reform strategy (Submission Part C, Section 1)

The Applicants argue that co-insurance is necessary to allow the public benefits of the Energy Reform Strategy ("ERS") to be delivered. We do not consider that the Applicants have demonstrated that the public benefits of the ERS would not be delivered in the absence of co-insurance. Throughout our response we present compelling arguments that demonstrate that the claimed public benefits of the ERS can be achieved and may, in fact, be better served, in the absence of co-insurance.

We note that in Part A, Section 4.3 of the Submission the Applicants suggest that the appropriate counterfactual for assessing the Applications is one where the ERS is not implemented. We consider that it is clear that the ERS can be implemented in the absence of co-insurance and, accordingly, the counterfactual suggested by the Applicants is inappropriate. The appropriate counterfactual is the implementation of the ERS without the co-insurance scheme. We have based our arguments on this counterfactual.

We deal in turn with each of the key claimed public benefits of the ERS, the delivery of which, the Applicants argue necessitates the implementation of co-insurance:

Competitive retail and wholesale electricity market in NSW

We consider that it is clear that a competitive retail and wholesale electricity market can be achieved in NSW without the implementation of co-insurance. We detail our reasons in sections 2 and 3 below.

Creating an industry and commercial framework to encourage private investment into the NSW electricity sector

We consider that viable private investment into the NSW electricity sector can be achieved in the absence of co-insurance and is not necessarily enhanced by the implementation of co-insurance. We detail our reasons in section 2 below.

Ensuring NSW homes and businesses continue to be supplied with reliable electricity

We do not consider that reliable electricity supply in NSW depends on or is improved by co-insurance. Rather, the opportunity to improve reliability arises through the implementation of the ERS more generally. The implementation of the ERS will open up investment in the NSW generation market to the private sector (as recommended by the Owen Inquiry) and in this way will create the opportunity for improved reliability irrespective of whether the ERS includes co-insurance.

Placing NSW in a stronger financial position by optimising sales value of public assets

While the optimisation of the sales value of public assets in NSW could be argued to be a public benefit (at least for a restricted NSW taxpayer definition of the public – not the Australian public more generally), it is only a short term public benefit. We consider that basing public benefit on short term, once off gains is dangerous and is not the intended basis for public benefit assessments in respect of authorisations under Section 88(1A) of the Trade Practices Act. Public benefit should consider the longer term implications of co-insurance, not simply the short term gains derived from the sales value of assets. We detail our reasons further in section 4 below.

2. Benefits from improved outcomes in the NEM Wholesale Market (Submission Part C, Section 3)

The Applicants argue that a co-insurance arrangement would deliver improved outcomes in the NEM wholesale market in three areas. We deal with each in turn. Additionally, in section 6 below we set out our specific concerns regarding the anti-competitive detriments that we consider arise from the proposed arrangement.

Structural Factors (Submission Part C, Section 3.1)

The Applicants argue that the co-insurance scheme is needed to allow the unbundling of the existing three Generator trading portfolios into the proposed five Gentrader portfolios without increasing the risk of unfunded difference payments. It is argued that an increase in the risk of the unfunded difference payments would tend to reduce the volume of firm contracts that Gentraders would be willing to enter into for a given level of risk. As we discuss further below, other measures exist for firming capacity, and the incentives of the competitive market may, in fact, lead to more firm contracts in a no co-insurance case than has been assumed by the Applicants.

Moreover, the Applicants' argument proceeds on the basis that it is critical to the ERS that the Gentrader model contains at least five portfolios (rather than three). No evidence is provided to support this position. Contrary to the arguments put by the Applicants, we do not consider that the Applicants' proposed structure requires co-insurance to support it, nor that the Applicants' proposed structure necessarily represents an optimal structure.

Encouraging new generation entry (Submission Part C, Section 3.2)

The Applicants argue that a new entrant to the NEM would be more likely to purchase a Gentrader contract if it was not required to manage its own contractual firmness risk. The assumption is made that, in the absence of a co-insurance arrangement, a new entrant will be in a riskier position to self-insure against the risk of unfunded difference payments than existing market participants. We consider that this assumption is erroneous. We would expect that parties interested in purchasing a Gentrader portfolio (irrespective of incumbency or new entrant status) would have experience in managing energy trading risks and their purchase of a Gentrader portfolio would be motivated by the desire to apply this expertise. This expertise should not be assumed to be the sole preserve of incumbents. It cannot be assumed that a new entrant would prefer a pre-arranged co-insurance scheme to the ability to manage their own risks or have the flexibility to innovate in risk management – which may well be their core competency.

In addition, we note that although encouraging diverse ownership of the Gentrader contracts has the potential to enhance market competition, this desire must be balanced against the need to encourage the participation of Gentraders who have the necessary capabilities to efficiently manage key market risks, such as the risk of plant outages. To the extent that the co-insurance mechanism encourages a new entrant who would only be viable if supported by the co-insurance scheme, this would effectively involve more efficient Gentraders being forced to subsidise a less efficient new entrant, leading to a reduction in market efficiency.

Facilitating liquid markets in firm contracts (Submission Part C, Section 3.3)

The Applicants argue that a co-insurance arrangement is important for facilitating liquid markets for firm contracts by providing Gentraders with the opportunity to offer a larger volume of firm contracts for a given level of risk. This argument overlooks other market options currently available to the Gentrader or its counterparty to "firm up" non-firm capacity. We outline some of these other options below. Moreover, it should be noted that the co-insurance mechanism proposed has been designed to increase firm capacity up to a specified level; however, this is achieved by reducing the reliability of capacity above this specified level, as it may be called upon for co-insurance purposes. In some cases the co-insurance arrangement may, in fact, reduce the amount of firm capacity available to the market by restricting it to the level specified by the co-insurance arrangement. This may be expected to occur where Gentraders have options available to them to offer firm capacity in excess of the level specified by the system Administrator.

Other options outside of co-insurance arrangements to firm capacity or utilise buyer firming include:

- *Owning a portfolio of generation assets:* While the NSW Government has indicated that one of its key aims is to encourage a new entrant Gentrader, it is likely that most of the Gentrader portfolios will be acquired by incumbent participants in the NEM. This increases the likelihood of Gentraders integrating the Gentrader assets as part of a portfolio and thereby being able to offer firm capacity in excess of the levels predicted by the "N-1" model outlined in the Applications. Further, in the case of a new entrant Gentrader, the inherent economies of scale in the market suggest that the Gentrader would be incorporated into a larger portfolio over time. We are of the view that this "self insurance" would be more efficient in managing outage risk than the co-insurance arrangement. This is based on the view that under co-insurance, Gentrader's have an incentive to sacrifice the overall economic efficiency of insurance arrangements to optimise their individual performance.

- *Use of insurance products:* A wide range of insurance products are available to counter the risk of unfunded difference payments. The range of products typically used by market participants may include traditional insurance products (such as plant outage insurance), price cap contracts (one way contracts for difference triggered during high price periods), other customised derivative products (such as weather-based derivatives that act as a proxy for high demand periods), use of risk capital to firm up the risk of unbacked difference payments, or a wider range of customised over-the-counter products and contractual agreements.

- *Innovative trading strategies:* One of the key ways that Gentraders may seek to achieve efficiencies within the market is through innovative trading strategies or contractual agreements to better meet the needs of energy purchasers. Such strategies can provide enhanced value to both buyers and sellers. This increase in market efficiency would be expected to filter through to more competitive retail electricity prices. The imposition of the co-insurance mechanism may restrict innovation by imposing a rigid process for managing outages. It may also restrict the amount of capacity that Generators can offer through firm contracts by adding the risk that Generators could face unfunded difference payment as a result of a co-insurance claim being made against them. This runs counter to the NSW Government's aim that the ERS will "increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities".

- *Buyer firming of non-firm Gentrader contracts:* Additionally, a buyer of non-firm contracts from a Gentrader may have the ability to firm the contract more efficiently than the co-insurance scheme would allow. This would be especially realistic if the successful purchasers of the retail assets were incumbent players with existing generation, demand side or hedging portfolios.

In the absence of the co-insurance arrangements it is anticipated that all Gentraders would resolve any firm capacity shortages by uncovering alternate and more efficient ways of increasing firm capacity available. These methods would be tailored to the risk profile of individual generators, unlike the co-insurance arrangement, which assumes that all generators have the same probability of outages and all Gentraders have the same appetite for risk. Further, Gentraders' independent risk management decisions would intrinsically take into account the physical characteristics of the power network, whereas co-insurance would not. For example, where a facility providing insurance was located further from where energy was required, the insurance would take energy losses into account through the contract price, while co-insurance would not. In our view, locking in a one size fits all co-insurance arrangement would reduce the likelihood and incentive for innovative risk management options to develop.

3. Benefits from improved outcomes at the retail level (Submission Part C, Section 4)

We consider the Applicant's arguments on the benefits of improved retail outcomes from co-insurance to be confused. On one hand the Applicants contend that the existence of co-insurance is a public benefit because it allows more efficient use of existing generation capacity, thereby deferring the need for retailers to underwrite new entrant capacity. On the other hand it is suggested that wholesale markets may become increasingly volatile due to a tightening supply/demand balance (conditions that would normally result in more investment). If there is a genuine tightening supply/demand balance (as has been identified in the Owen Inquiry and used as the basis to pursue the ERS), it would be detrimental to the public benefit if the co-insurance scheme artificially deferred the building of new generation assets as suggested by the Applicants' argument.

4. Benefits to the State of NSW (Submission Part C, Section 5)

The assertion that co-insurance will benefit the public interest by increasing revenue to the NSW Government provides a questionable definition of public interest, particularly given the potential for the co-insurance to impact all participants in the NEM, including those outside NSW. Further, while the optimisation of the sales value of public assets in NSW is a public benefit, it is only a short term public benefit. We consider that basing public benefit on short term, once off gains is dangerous and is not the intended basis for public benefit assessments in respect of authorisations under section 88(1A) of the Trade Practices Act. Public benefit should consider the longer term implications of co-insurance, not simply the short term gains derived from the sales value of assets.

In addition, we note that increased proceeds from the sale will necessarily imply higher payments for Gentrader contracts which would in turn be recouped from the market. While market returns are likely to be determined by competition (and not by pass-through of costs of acquisition); at the margin Gentraders who have paid more for their contracts will face a stronger incentive to increase pool revenues than if they had paid less. As any outcomes resulting from this incentive will spill into other NEM regions (and because there is not a one to one relationship between electricity users and taxpayers in NSW) higher proceeds to NSW taxpayers are not the same as public benefits across impacted electricity consumers.

Even putting aside the questionable use of sales value as an appropriate test of public benefit, the assumption that a co-insurance arrangement will result in an increased level of availability and thereby increase the sale price of assets makes two assumptions that are materially problematic. First, it assumes the levels of firm capacity will necessarily be increased by co-insurance (as discussed previously we do not accept this assumption). Second, it assumes that co-insurance will mitigate the volatility of power availability without having broader impacts on the risks faced by potential acquirers of the Gentraders. It is expected that most potential acquirers of Gentrader assets will value these assets using some form of discounted cash flow methodology. The principal underlying this method is to model the future cash flows of an asset and develop an assessment of its present value by applying a discount factor to each cash flow. The discount factor reflects an assessment of the riskiness of the asset. Within the discounted cash flow framework, all other things being equal, a reduction in the volatility of cash flows as a result of the co-insurance arrangements would result in a lower discount rate and higher present value. However, this ignores other perceived sources of risk that may arise for Gentraders from the co-insurance itself. Perceived risks arising from the co-insurance may include:

- *Credit risks:* The Applicants' Submission states that "co-insurance payments balance out as far as the Government is concerned. Importantly though, individual Generators stand to gain or lose from the arrangements so the commercial Boards of these corporations will be concerned about their availability and the costs to them of calling for co-insurance support."

  While it may be the case from the perspective of NSW Treasury that the Generators' payments will cancel out, the NSW Government has provided no explicit guarantee that it will support individual Generators in the event of their default. Under the ERS Gentrader proposal, Gentraders will pay Generators a fuel payment to be passed on to suppliers and a fixed contract payment that will constitute the Generator's payment stream. Given that the Generator's revenue stream is fixed, the imposition of penalty payments or liquidated damages in the event of outages could have a material impact of a Generator's solvency. While the NSW Treasury may remain whole, there remains the risk that an individual Generator may become insolvent. Without an explicit Government guarantee, this credit risk is a material risk to Gentraders.

- *Potential conflicts with Generators over maintenance schedules:* Under the Gentrader arrangement, the Generators and corresponding Gentraders must agree on an operations and maintenance schedule for each Generator. As Gentraders receive co-insurance payments in the event of an outage and Generators must make them, these two parties have different incentives which may lead to conflicts over maintenance schedules. Gentraders may have concerns that Generators will seek to "over maintain" assets to reduce the risk of unplanned outages by having an excessive number of planned outages. While this may be an issue for all Gentraders, this issue may be particularly relevant for new entrants without experience scheduling plant maintenance at other facilities.

- *The 10 year term for the co-insurance arrangements:* Given the risks associated with the co-insurance arrangements, it would be a material imposition to be locked in to this arrangement for 10 years. Even if the co-insurance arrangement involved a material detriment to a majority of Gentraders, the NSW Government Submission suggests that unanimous consent would effectively be required to remove the arrangement. This may give a single Gentrader who favours co-insurance the ability to force other Gentraders to retain it, despite it being broadly detrimental. Although, we are of the view that co-insurance is not justified in any circumstance, if the Commission is minded to allow it, we consider that the term should be significantly reduced to represent a transitional arrangement only. Typical transition arrangements would not extend beyond one year to allow players to make their own arrangements.

- *Gentraders may have material concerns about risks arising from the behaviour of other market participants:* For example, Gentraders may have material concerns about the risks arising from having to provide insurance cover to other market participants whose risk of outages or expected bidding behaviour cannot be adequately assessed.

The risks of these types of events, whether real or perceived, will be factored into the valuation of the Gentrader contracts. Accordingly, it is possible that potential acquirers may apply a higher discount rate to the cash flows than in the absence of co-insurance, resulting in lower asset valuations.

The Applicants' Submission assumes that co-insurance will impact Gentraders consistently. There are a number of reasons why this is unlikely to be the case, including:

- there are different types of physical assets at each of the generation sites, which suggests that Generators will face different probabilities of outages (and there is historical evidence supports this);
- sites may have different levels of susceptibility to outages due to their physical location in the network; or
- different Generators may have differing views on the costs of outages, which may result in different operation and capital expenditure decisions.

Given that the frequency and duration of outages may be expected to vary between Generators, the perceived benefits of co-insurance may also vary and this will impact perceived asset value. It is possible that the co-insurance arrangements may increase the value of assets that may be expected to have more frequent outages, but reduce the value of the best performing assets that may be expected to have to provide co-insurance.

5. Benefits to Gentraders (Submission Part C, Section 6)

The Applicants provide some indicative graphs to demonstrate how a co-insurance arrangement may increase firm capacity compared to a situation where all parties take raw exposure to plants. We do not dispute that the co-insurance would have some impact on firming up capacity. However, as we have outlined above it is not the only, nor the best, means of achieving this result. Moreover, the Applicants' analysis assumes common risk appetite and policy across Gentraders – which is the case when common Government ownership is in place, but is not the case when independent Gentrader owners are in place.

6. Negligible anti-competitive detriments (Submission Part C, Section 8)

We dispute the Applicants' claim that co-insurance will have negligible anti-competitive detriments. In addition to the arguments we have made which demonstrate that co-insurance is not required to improve market efficiency, TRUenergy has specific concerns that the co-insurance mechanism proposed may not promote efficiency and may even produce perverse market outcomes. In particular:

- *Uncontracted capacity information is common between Gentraders:* Co-insurance creates a situation where Gentraders all know at least how much uncontracted capacity each will have. In situations where all plants are in service, and demand is high, this can increase incentives for Generators to set high pool prices (in a manner not dissimilar to seen under the current ETEF scheme). Incentives of this kind undermine competitive pressures and are, therefore, not aligned with public benefits.
- *Increased incentive for pool exposure under co-insurance scheme:* Given that the co-insurance scheme will effectively mean that non-firm capacity needs to be available to cover co-insurance calls should they arise, one key impact of the co-insurance scheme may be that Gentraders will be forced to maintain significant

spot market positions compared to what they may otherwise have arranged to take. All of the Gentraders have an incentive to maximise pool revenues when market conditions call for dispatch greater than firm contracted levels, hence the co-insurance scheme could lead to higher pool prices during these periods. If the co-insurance scheme was not in place, Gentraders may have an incentive to forward sell unencumbered non-firm capacity which would remove incentives to attempt to set high pool prices to maximise spot revenue.

Clearly, a systemic incentive across all Gentraders to set high spot prices when market conditions allow (eg when all Generators are in service, and demand is high), could significantly increase NEM pool prices averages given the high Market Price cap in the pool. Such a systemic incentive would be unlikely to develop in the absence of the co-insurance schemes, as each Gentrader would compete in the contract market to maximise revenue in an environment with no certainty about how other generators will behave in the spot market (and the risk that failing to contract could leave them exposed to low pool prices, resulting from heavy contracting amongst their competitors).

If the co-insurance scheme is not implemented, there will be great uncertainty over how competitors will act which will support contract market competition as occurs in other regions of the NEM. This outcome is more aligned with general public benefits than a program including the co-insurance scheme which provides information about how competitors are likely to be positioned in the pool.

- *Signalling mechanisms:* Design features such as the energy-weighted surplus/deficit order suggest that there will be some market conditions that are conducive to calling on co-insurance and other periods where Gentraders would avoid making a co-insurance call. Other features of the co-insurance scheme design are also expected to create incentives for particular behaviours, for example:

  - ❑ a Gentrader experiencing an outage who expects prices to be high late in the day may call for co-insurance immediately. A Gentrader expecting low prices will not; or

  - ❑ a Gentrader who has reduced expectations of the technical or economic life of the Generator within the co-insurance horizon may be far more willing to make co-insurance claims.

  It is expected that, over the proposed 10 year duration of the co-insurance mechanism, such behaviours will become familiar to market participants. As such, Gentraders may behave in such a way that either calling or failing to call on co-insurance may reveal information to other market participants on their future behaviour. These 'signalling effects' may result in a reduction in competitive bidding or an increase in opportunistic bidding within the market.

- *Potential impact on other markets*: It should be noted that the Applicants' Submission focuses on the impact of the Gentrader arrangements for the NSW electricity market. However, interconnections between NEM regions suggest that the implications of the co-insurance arrangement could have ramifications beyond NSW. For example, the opportunity cost of NSW Gentraders having to engage in market-based hedging strategies may be a lower volume of trade on contract markets than would otherwise be expected. A reduction in the volume of contracts available could be expected to reduce liquidity in these markets. Further, any reduction in market efficiency as a result of the co-insurance arrangements may be expected to lead to higher wholesale electricity prices both within and outside the NEM.