



26 May 2011

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Pierce,

**Re: Consultation Paper – Potential Generator Market Power in the NEM**

Loy Yang Marketing Management Company (LYMMCo) makes this submission in response to the Australian Energy Market Commission's (AEMC) Consultation Paper on Potential Generator Market Power in the NEM, despite reservation surrounding the appropriateness of the process.

LYMMCO trades the largest privately-owned generator in the National Electricity Market (NEM). 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. LYMMCo, as an entity, was created as a consequence of Federal Court of Australia undertakings, in matters actioned by the Australian Competition and Consumer Commission (ACCC),

Given the topic at hand includes issues with laws and policy matters outside the remit of the AEMC, LYMMCo does not consider the analysis outlined by the AEMC has authoritatively indicated that the AEMC is the suitable entity to undertake this work.

In this regard, based on the current analysis, we would have significant concerns with the AEMC seeking to support changes to laws administered by existing and suitably charged bodies, like the ACCC, or duplicating those laws for the purpose of creating duplicate authority for other bodies to pursue competition matters.

In simple terms, the existing competition law framework provides an avenue for concerns regarding market power. We are not convinced that the AEMC should be involved in that process, and believe the AEMC has not sufficiently assured market participants it is in the AEMC's charter to review matters of market power.

Nevertheless, should the AEMC wish to comment on these matters, LYMMCo wonders whether such an analysis would more appropriately focus on the efficiency implications of capping large market participants at \$300MWh, and whether market signals are appropriate to drive new entry plant as opposed to a discussion on market power per se. This would appear to be the form of analysis the AEMC has noted experience in undertaking.

It is possible that this is the AEMC's intention; however, we suggest that point has not yet been appropriately conveyed to market participants and hence adds to the range of additional concerns investors in the NEM presently face.

## **Discussion**

### **Market power in the context of the NEM**

LYMMCo believes that in the absence of a compelling argument not to use the legal definitions pursuant to the Commonwealth's *Competition and Consumer Act (2010)* (CCA), the AEMC should confine its discussion to the existing provisions governing market power.

LYMMCo suggests the AEMC take caution in attempting to guess the preferred approach of the courts in interpreting market power. The AEMC is not, by any measure, a judicial body and any steps that lead to a suggestion that entities have exercised market power in light of any AEMC adopted definition of market power may not be well received.

LYMMCo agrees that the issue of potential competitors is a critical factor. The potential for: a new generation entrant; construction of an interconnector subject to the relevant regulatory cost benefit; customers choosing to contract with alternative players or on the Sydney Futures Exchange; funding on-site generation by load; and, entering the spot market, are all actions available to participants in the spot and contract markets.

This does not mean, by any measure, that those alternatives will always work and provide cheaper energy for any individual load (or greater revenue for a generator). But this is the nature of markets and arguably a driver behind the proposal.

### **Exercise of market power in the NEM**

As already indicated LYMMCo does not believe the AEMC should be seeking to lower or change the standard for assessing market power given the existence of existing legislation in this area.

LYMMCo agrees that an analysis of price outcomes (over the long-run) is most likely to determine whether generator revenues are in excess of what would be expected in the absence of competition and potential competition. Whether the spot and forward markets have operated for long enough to make such a judgement is unclear but nevertheless, even if those returns were above "average" this does not of itself indicate the existence of market power. In any case, generator returns on assets are historically not excessive in Australia.

### **Impact of market power on efficiency**

The measures of market power, outlined by the proponent, have limited validity. Major corporations' incurring substantial losses is not an indicator of the exercise of market power. It can be explained much more simply.

An increase in retail contract prices or a general increase in electricity prices is not a determinant of market power and also are yet to be demonstrated. These outcomes can be explained by a number of variables and as a consequence of general market conditions. LYMMCo, as it stands, is not convinced these outcomes are even recordable to date.

The existence of barriers to entry, as opposed to an absence of entry, and the experience of retailers is of interest when considering if market signals are appropriate. However, LYMMCo notes our experience in Victoria is of increased entry of retailers and a reduction in market share of major vertically integrated retailers. The relevant State regulators data in this area supports this.

As it relates to the possible losses in allocative, productive and dynamic efficiency alluded to in the AEMC's short analysis, LYMMCo suggests a measure of proportionality is needed. There is a mindset amongst some that any high price, or indeed any bid above short-run marginal cost, is inefficient and not in the long-term interests of customers. This view is contrary to the foundation of the NEM and should not be supported, indirectly or directly in light of possible minor inefficiency losses in the short-run.

In addition, the AEMC should not imply only occasional high prices are efficient thereby implying regular high-priced events should be judged inefficient. LYMMCo is yet to see a measure of ideal NEM volatility. Therefore, we do not consider it a necessary part of this exercise for the AEMC to discuss optimal occurrence of high-priced events. We suggest the occurrence of high prices is not of itself a gauge of the market's success. If it were, then low price events are just as worthy of consideration. This is because generator bidding drives pricing in both directions and they both can arguably direct investment signals and effect commercial outcomes.

One area where we believe the AEMC has mischaracterised the discussion is in relation to efficiency impacts in derivatives markets. The analysis seems to imply that higher spot prices reduce retail competition and leave load exposed as futures contracts, the primary instrument to hedge against spot prices, will become significantly more expensive. We are not convinced the evidence demonstrates this or that any single explanation is likely to cover the range of outcomes experienced by competing commercial entities in such a dynamic market.

For example, in LYMMCo's view the forward markets are best viewed as an opportunity for counter-parties to manage risk (and others to speculate) by locking in fixed prices in the outgoing years. Therefore, higher spot price volatility is likely to increase the desire for some entities to contract (including generators to the extent they can manage physical transmission risk) to provide stable outcomes in the outgoing years.

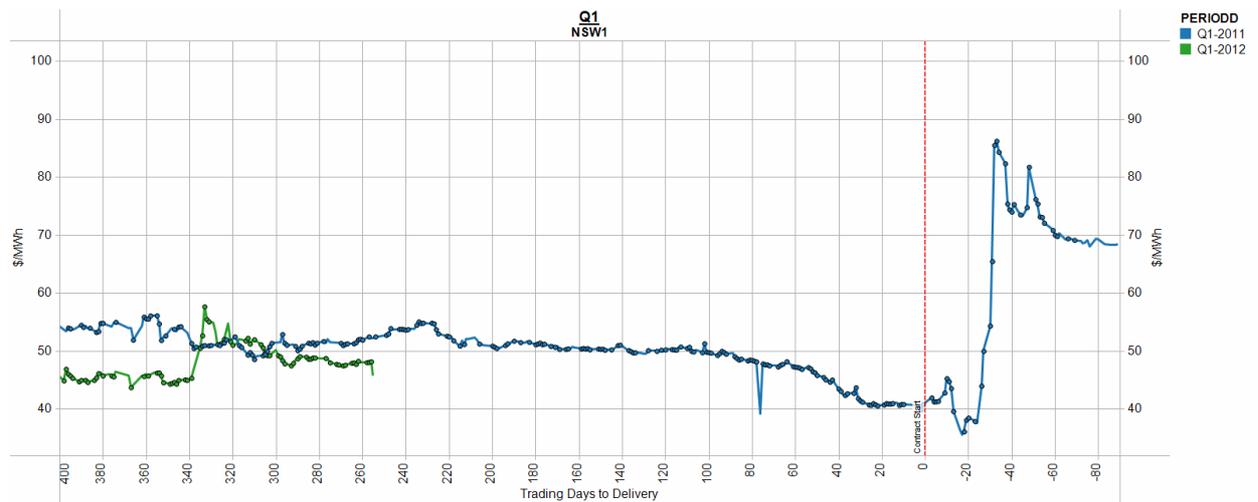
While a more fulsome examination of contract data will be required, our broad observations suggest that the forward markets have matured significantly to meet a range of entities needs, has high liquidity in the major nodes, and for all recorded nodes prices trend around the long run average in the pool.

For example, Chart 1 below shows the prices of futures and OTC broker trades for NSW Q1-2011 and Q1-2012 contracts from 400 days before delivery (delivery meaning the start of the actual quarter being traded). This means across the x axis is 400 days out from the start of the corresponding quarter on 1 January. For Q1-2011 this is 400 days prior to 1 January 2011, so measurement commences in late 2009. For Q1-2012 this represents 400 days from late 2010 until prior to 1 January 2012 (hence why the line is not complete for Q1-2012).

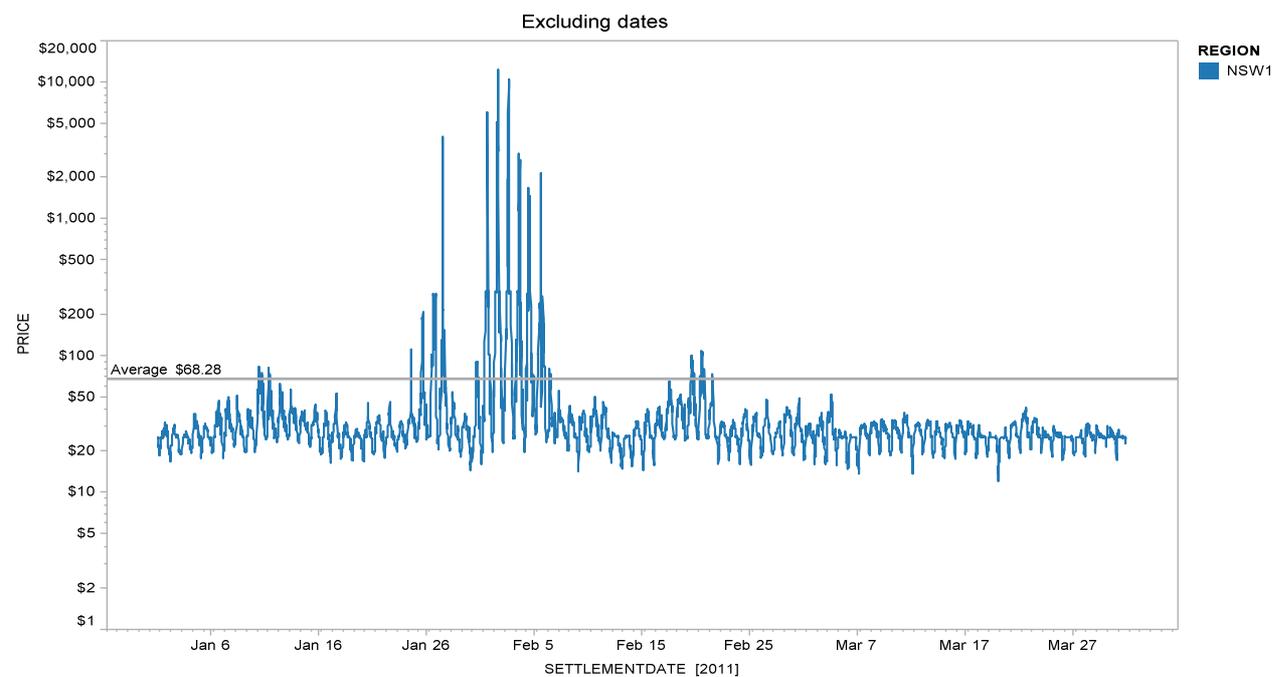
As can be seen, Q1-2011 traded between a low of around \$40 and a high of around \$56 across the 400 days prior to the delivery date of 1 January 2011. A significant price change can be seen 30 days after Q1-2011 commenced and results in trades above \$60 with many more trades between \$70 between days 40 and 60 after Q1-2011 commences. This is hardly surprising as evolving weather expectations, and then pool volatility, would drive those speculators and those participants without cover to seek Q1-2011 contracts once the quarter commenced and pool and weather outcomes lead to a re-evaluation of entity position and strategies. The NSW Q1-2011 spot market outcomes are provided in Chart 2 below.

It is illustrative to juxtapose the Q1-2011 post delivery date outcomes with prices for Q1-2012 also in Chart 1. As we can see, when Q1-2011 prices spiked - 30 days after Q1-2011 delivery date which is at less than 335 days from the start of Q1-2012 (i.e. 1 January 2012) - Q1-2012 forward contracts jumped notably. This is not surprising. While we cannot assume which parties purchased these contracts, it seems clear that Q1-2011 spot price outcomes have impacted decisions about current Q1-2011 and Q1-2012 positions. However, what is important to note is that Q1-2012 prices trend rapidly back towards the average earlier than the higher prices for Q1-2011 prices in the corresponding days (i.e. prices for Q1-2012 are back in the \$40's by the end of February 2011).

**Chart 1: NSW Q1-2011 and Q1-2012 futures and OTC**



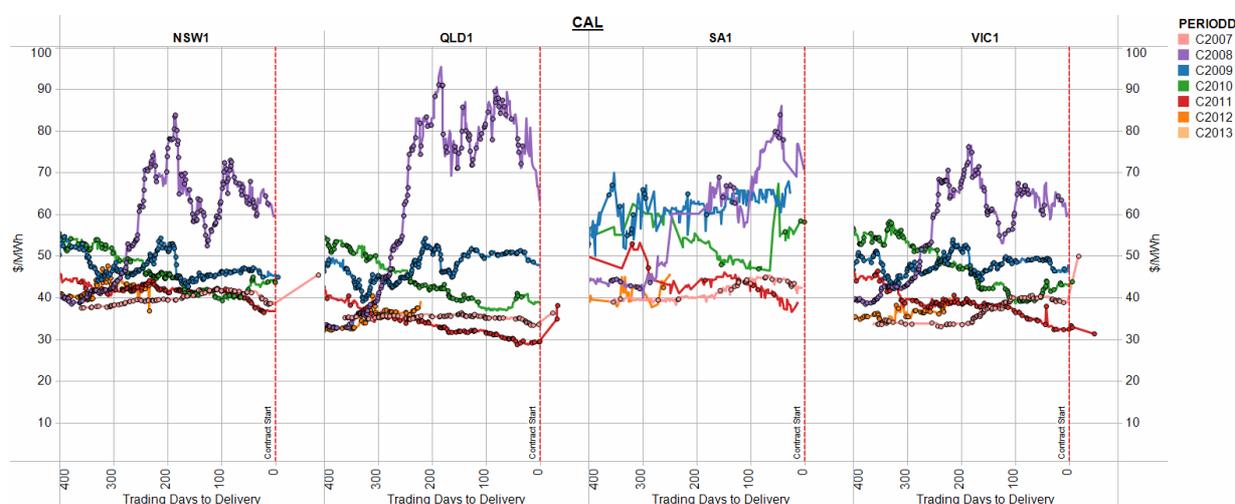
**Chart 2: NSW Q1-2011 spot price outcomes**



LYMMCo believes the NSW example is illustrative of the type of experience it has observed in the NEM over the course of its maturation. However, we agree that one quarter, at one node, is not sufficient analysis to draw any solid conclusions.

Chart 3, which shows futures and OTC broker trades by calendar year 400 days prior to delivery provides additional context. Notably, while liquidity differs between nodes, and the level of direct OTC is likely to vary, the price range between regions is not markedly different across futures and OTC broker trades. This is especially the case when one takes into account that different price outcomes should be expected between nodes given: interconnector limits; demand differences; retail price regulation; generation profiles; numbers of competitors; generators reliability; network capability and outages; and impacts of natural (i.e. some places are generally always hotter) and irregular weather patterns (droughts affect some regions greater than others).

Chart 3: Futures and OTC outcomes by year



Arguably, it is not surprising that forward contracts' trade history share similarities over the longer-run as spot market trends over the history of the NEM, as detailed in Table 1, while not identical, are similar. This is not to suggest that identical prices are an appropriate outcome, merely the data is provided for discussion purposes and to note that based on yearly price outcomes it is not possible to suggest one region raises ongoing concerns on price alone.

Table 1: Historical pool outcomes

REGION		SETT_DATE														Grand T..
		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	
NSW1	Peak	\$23.13	\$25.23	\$41.57	\$42.95	\$48.05	\$36.02	\$66.18	\$55.14	\$43.31	\$97.40	\$53.14	\$67.63	\$39.80	\$85.15	\$52.35
	Off-Peak	\$16.79	\$20.76	\$31.21	\$25.97	\$33.51	\$19.10	\$29.03	\$21.28	\$21.74	\$44.06	\$28.49	\$25.80	\$24.13	\$28.86	\$27.10
	Flat	\$19.29	\$22.69	\$35.63	\$33.27	\$39.76	\$26.40	\$45.14	\$35.83	\$31.01	\$67.07	\$39.14	\$43.92	\$30.89	\$52.68	\$37.97
QLD1	Peak	\$40.96	\$66.33	\$70.01	\$46.26	\$61.70	\$29.74	\$47.24	\$34.77	\$36.28	\$97.35	\$58.82	\$48.55	\$33.85	\$71.35	\$53.18
	Off-Peak	\$23.06	\$21.85	\$34.72	\$25.84	\$37.29	\$17.05	\$24.82	\$17.98	\$18.26	\$43.84	\$32.58	\$23.18	\$19.26	\$26.72	\$26.38
	Flat	\$31.30	\$41.73	\$50.39	\$34.96	\$47.82	\$22.52	\$34.51	\$25.17	\$25.97	\$66.84	\$43.87	\$34.13	\$25.53	\$45.41	\$38.01
SA1	Peak	\$40.23	\$74.95	\$76.21	\$58.33	\$43.49	\$34.82	\$53.18	\$44.76	\$50.42	\$78.04	\$114.44	\$108.08	\$64.36	\$70.15	\$66.81
	Off-Peak	\$21.42	\$37.90	\$41.54	\$29.08	\$29.17	\$20.51	\$32.87	\$25.25	\$29.89	\$42.02	\$30.06	\$24.33	\$22.13	\$24.12	\$30.12
	Flat	\$30.08	\$54.46	\$56.93	\$42.15	\$35.32	\$26.66	\$41.61	\$33.60	\$38.68	\$57.50	\$66.37	\$60.47	\$40.28	\$43.40	\$46.02
TAS1	Peak							\$109.08	\$42.89	\$62.85	\$57.21	\$67.48	\$26.08	\$30.47	\$55.98	
	Off-Peak							\$81.95	\$31.26	\$52.00	\$43.67	\$36.23	\$34.78	\$27.04	\$43.15	
	Flat							\$94.11	\$36.44	\$56.85	\$49.73	\$50.20	\$30.89	\$28.56	\$48.89	
VIC1	Peak	\$24.13	\$27.23	\$45.56	\$52.10	\$43.02	\$31.17	\$39.29	\$34.33	\$47.41	\$90.51	\$53.79	\$54.45	\$51.75	\$44.35	\$47.36
	Off-Peak	\$16.72	\$19.00	\$32.76	\$23.88	\$25.71	\$17.02	\$23.00	\$20.27	\$24.18	\$42.98	\$29.99	\$22.85	\$21.40	\$24.29	\$25.19
	Flat	\$19.65	\$22.55	\$38.22	\$36.01	\$33.15	\$23.10	\$30.04	\$26.29	\$34.13	\$63.40	\$40.23	\$36.48	\$34.44	\$32.69	\$34.71

## **Evidence of market power**

LYMMCo has from time to time expressed concerns regarding ownership structures in some regions which we believe don't best support the competitive dynamics of the NEM; however, we do not, for the purposes of this rule change, support the proponent's views.

LYMMCo cautions the AEMC about what we consider leading questions. We are not convinced a public submissions process should be used to call for evidence of this nature. The AEMC has erred in asking these questions in this manner.

The AEMC has not sought to examine possible long-run inefficiencies which cannot be overcome by the market, either higher than required prices or lower than required prices for the market to clear and generate required capacity, but by requesting "evidence" has in effect sought to shame generators any party, under the cover of a rule change consultation paper, can claim use "market power to increase the wholesale price".

The AEMC should be under no illusions that such claims may be damaging to the reputation of those individual companies and to the operation of the NEM.

LYMMCo holds the view the CCA is appropriate to address the exercise of market power by generators; we do not support specific NER rule provisions, and believe any concerns regarding market power should be directed to the ACCC.

## **Effect of the proposed rule**

LYMMCo does not believe this leg of the analysis is legitimate in the absence of evidence of market power and in the absence of a case which demonstrates the CCA is not effective.

## **Other options to address the exercise of market power**

In the absence of a compelling case to address market power other than pursuant to the CCA, and in the absence of a compelling case that the long-term interests of consumers are not being met by the existing energy only market, LYMMCo does not intend to comment on the options outlined and again cautions the AEMC.

As it relates to the CCA, we understand its application differs for government owned entities than for privately owned entities and as a consequence in regions where there is complete or dominant government ownership there may be issues which to the application of the CCA. This arguably relates more to the appropriateness of ownership arrangements in a commercial market than the CCA's appropriateness in managing anti-competitive behaviour by commercial entities.

## **Impacts of the proposed rule**

The proposed rule change undermines the current reliability standard and settings arrangements which have been concluded as a consequence of extensive and ongoing consultation over the course of the NEM's existence.

The proposed rule would have a negative impact on generation investment incentives and to suggest otherwise is counter to the logic that underpins the analysis regarding the market price cap and decisions to increase that setting over time to reward capacity when it is utilised.

The proposed rule change undermines the operation of an energy only market and the proponents attempt to seek some level of insulation from the dynamics of the pool which they have chosen to participate in is inappropriate.

We believe the products available and the contract premiums paid by retailers and load in past years are highly competitive in terms of cover for pool volatility in the long-run, and if anything arguably is below the level needed, especially in recent years as the market has matured, to recover long-run marginal costs for some generators.

Therefore, we find it difficult in an environment where the 26 May 2011, 365 rolling day average prices are: \$27.08 for Victoria; \$37.13 for NSW; \$30.56 for Queensland; \$32.62 for South Australia; and \$29.51 Tasmania; to believe that there are any fundamental concerns around the use of market power to generate “excessive” high prices.

### **Conclusions**

In part, this rule change is promoting the view that high price volatility is not efficient, does not provide an effective price signal, and undermines the long-term interests of customers. LYMMCo does not endorse these views, and notes such issues have debated before and holds the view that incremental changes of this nature would have the effect of unravelling the energy only market in an environment where regulatory creep and government policy is already undermining effective private investment.

We believe the desire of some stakeholders to go back to the comfort and security of a tightly controlled system which does not require large commercial entities to consider the effective trade-off between pool exposure and contracts does not justify change or the investigation of change.

LYMMCo on the whole believes the market continues to operate effectively and that price outcomes are the key signal for new investment and profitability of existing plant. Should a stakeholder or other parties be of the view that market reform is required, for example a move away from the energy only format, we suggest an appropriate case must be made and that a more fundamental analysis would be required.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Jamie Lowe'.

Jamie Lowe

**Manager, Regulation and Market Development**