



15<sup>th</sup> September, 2011

Committee Secretary  
Senate Select Committee on the Scrutiny of New Taxes  
PO Box 6100  
Parliament House,  
**CANBERRA ACT 2600**

Sent by email: [Hugh.Griffin@aph.gov.au](mailto:Hugh.Griffin@aph.gov.au)

**SENATE SELECT COMMITTEE ON THE SCRUTINY OF NEW TAXES  
INQUIRY INTO A CARBON TAX**

**SUBMISSION FROM LOY YANG POWER**

The attached submission is provided for the above Committee in order to summarise the key issues that Loy Yang Power has identified in relation to the proposed clean energy legislation.

The company appreciates the opportunity to appear before the Committee and trusts that the attached documentation will assist it in the hearing scheduled for the 16<sup>th</sup> September, 2011.

Yours sincerely,

**KEN THOMPSON**  
EXECUTIVE GENERAL MANAGER – LOY YANG MARKETING

Att.

ACN 077 985 758

**LOY YANG POWER MANAGEMENT PTY LTD**  
PO BOX 1799 TRARALGON 3844 VICTORIA AUSTRALIA  
Tel +61 (0)3 5173 2000

## **LOY YANG POWER - OVERVIEW**

Brown coal generation is highly carbon emission intensive. The annual emissions of Loy Yang Power (LYP) are approximately 19.5 million tonnes. Based on the \$23/tonne starting price, the proposed clean energy scheme will result in an additional \$450 million in costs for the LYP business from the first year of the scheme.

The nature of the competitive national electricity market (NEM) means the full cost of carbon incurred by high emitting coal-fired generators will not be passed through in wholesale electricity prices. As a result, highly emission intensive coal-plant will face reduced operating cash flows and in some cases force generating plant to close. LYP is expected to remain a cornerstone in meeting Victoria's electricity supply requirements well into the next decade, however the business faces significant challenges in preparing for and mitigating the impacts of the carbon price mechanism.

The Energy Security Fund announced as part of the Clean Energy Future Bill is expected to provide assistance for generators significantly impacted. This should mitigate energy security concerns in the short term, however our internal modelling predicts that LYP will still face a significant reduction in business value. In addition, the carbon price mechanism will create significant additional demand for working capital (and variation in net cash flows) to meet carbon permit purchase and surrender obligations.

These outcomes are likely to reduce the creditworthiness of brown coal-fired generators, impacting on their ability to enter into forward electricity contracts and forward contracts for carbon permits to mitigate their associated carbon exposure. This is expected to lead to higher electricity prices for end use customers.

## **SCHEME DESIGN ISSUES**

### **No deferred settlement facility option available at auction**

Electricity generation businesses will need to hold positions well in excess of \$10 billion at any one time to manage their collective exposure under the carbon scheme (about 40% for current year obligations and 60% for forward contracting).

The option to pay for future vintaged permits upon delivery (as opposed to when they are purchased at auction) is fundamental to liable parties' ability to manage their considerable carbon exposure.

The working capital requirements associated with paying for these future permits upfront will be financially stressful for all liable parties, prohibitive in some cases, and impossible in others given arrangements with financiers.

Significant work had been done previously between Energy Supply Association of Australia (*esaa*) and Department of Climate Change (DCC) during the CPRS deliberations to develop an agreed deferred settlement facility for future vintage permits purchased at auction. The consultation between *esaa* and DCC also developed potential auction timing, frequency, volumes, and settlement arrangements. These arrangements should be incorporated as part of the current scheme developments to achieve a workable arrangement for liable parties.

It is acknowledged that the Government may provide loans to assist generators in purchasing permits at auction, however existing loan arrangements in some cases may prevent companies from accessing such loan offer. If deferred settlement options were available at auction then such Government lending would not be required.

### **Limited release of future vintage permits at auction prior to the establishment of scheme caps**

On scheme commencement, future vintage permit auctions will be a key source of permits to enable carbon exposures associated with forward electricity hedging to be managed.

Auctions for forward vintages must commence as soon as possible within the fixed price period and preferably from commencement of the scheme on 1<sup>st</sup> July, 2012, in sufficient volume, to be an effective means of acquiring permits.

The announced 15Mt limit that would be offered in advance of the first floating price period is ineffective for electricity market participant requirements, and grossly inadequate in terms of the likely market demand for forward vintages.

Assuming about half of the total emission cap is released via auctioned permits a limit of 150 million permits would ensure liquidity and would not expose the Regulator to the risk of over-allocation of permits in the process.

### **Cash payment under the Energy Security Fund**

Company directors cannot rely on the value of the cash payment included in the 'Clean Energy Future' policy announcement because it is non-firm and unenforceable. Plainly, such a situation will raise material working capital and solvency issues, which would in turn undermine Australia's energy security.

Though the method for division of the cash payment has been clarified in the commentary to the draft bill tabled in Parliament, the value of the cash payment has an effective value of zero until it is actually delivered. Passage of the current bill(s) will not remedy this.

For the cash payment to constitute effective assistance and resolve reliance issues for company directors, the Government must include a default provision in the bill(s). An alternative would be to establish another formal mechanism that provided the level of certainty regarding its payment / value to recipients necessary for the governance of businesses, no later than potential passage of the bill(s).

### **Price floor on international permits surrendered.**

A price floor is incompatible with the use of a market-based policy mechanism for reducing emissions and raises the cost of compliance under a carbon scheme without any additional environmental benefit.

It is important to underscore that hedging carbon exposure forward is compounded by foreign exchange exposure and risk differences in primary and secondary markets; and the result is often very complex cost structures negotiated potentially years in advance of when a liable party will surrender units.

The ability to lock in a certain total purchase cost for an international unit on the trade date is integral to participants' motivation to use forward markets to hedge their carbon exposure. A price floor mechanism that unintentionally interfered with this ability would severely dilute the risk management benefits available from forward contracting.

It is important to note that options for forward contracting for the purchase of domestic units under the proposed carbon scheme are extremely limited if deferred settlement is not a feature of domestic auctions.

Assuming the concept of a price floor is maintained in the bill, the concept of an "International Unit Surrender Charge" (or "fee on the surrender of international units") must be removed to avoid pre-empting the development of an appropriate workable approach to the extent this is possible.

A broad range of approaches needs to be thoroughly considered in developing a regulation that gives the effect of a price floor without impeding efficient forward trading.

### **Taxation arrangements for permits**

LYP notes that the Government will legislate to make supplies of permits GST-free. This is a welcome improvement on the CPRS position and supported.

However, as was detailed in a recent submission by the esaa to the Clean Energy Legislative Package (to which LYP was a signatory) the proposed tax treatment of emission permits under income tax law remains a concern.

Of particular importance is the way in which the cash payment component and administratively allocated permits under the Energy Security Fund are treated for income tax purposes which, under the current drafting of the bill(s), causes unnecessary cash flow implications for recipients and potentially biases their decisions towards acquittal or liquidation over banking.

The most appropriate treatment is to allocate a nil value to free permits (reflecting their historical cost) rather than a market value.

Under this approach free permits would not effectively be assessed as income or as a deduction serving to remove cash flow implications and any biases that might have been caused.