Senate New Taxes Committee
Tabled Document
Inquiry: CARBON
Date / Time: 10:56 am
Witness Name: Loy Yang Power
Organisation: Ken Thompson

KEN THOMPSON SPEECH

SENATE SELECT COMMITTEE ON THE SCRUITINY OF NEW TAXES

INQUIRY INTO CARBON PRICING MECHANISMS

16 September 2011

I would like to thank the Senate Select Committee for the opportunity to present today on behalf of Loy Yang Power. I would also like to apologise for the absence of our Chief Executive Ian Nethercote, who is unable to attend as he is overseas on business this week.

Loy Yang Power is located in the Latrobe Valley, a region that has been the heart of the Victorian power industry for nearly 100 years. Today, Latrobe Valley brown coal supplies around 85 per cent of Victoria's energy needs and employs around 3000 people. The industry's direct contribution to the economic output of the region has been estimated at more than 20 per cent; higher than any other industry sector.

Given the economic and environmental impact of the Latrobe Valley brown coal power industry, there is no doubt that the proposed carbon scheme will place significant pressures on this industry and this community and it is clear that the Latrobe Valley will need special assistance due to the dislocation likely to be caused by the transformation to a low carbon economy.

Loy Yang Power is Victoria's largest power station with a 2,200 MW capacity, providing one third of Victoria's electricity demand. The Loy Yang mine produces approximately 30 million tonnes of coal a year and also supplies the nearby 1000 megawatt Loy Yang B power station owned by International Power GDF Suez and Mitsui. This means the Loy Yang Power mine is the fuel source for approximately 50 per cent of Victoria's energy needs.

Loy Yang Power has taken very seriously the issue of greenhouse emissions and climate change for well over a decade and has committed significant capital investment on plant efficiency programs which have increased generation output by 200 megawatts while also reducing the amount of carbon produced per unit of energy.

We have also supported a range of research and development projects which could significantly reduce CO_2 emissions from brown coal generation while opening up new opportunities for the use and export of the vast brown coal resources which exist. At current usage rates, there is approximately 500 years of brown coal available in the Latrobe Valley. We believe it is vital for our region and the nation that we continue to harness the brown coal resources of the Latrobe Valley into the future in a responsible and sustainable manner. New technology will certainly be critical for the future utilisation of brown coal in the Latrobe Valley.

Before commenting on specific aspects of the Clean Energy Bill, I would like to emphasise that Loy Yang Power is seeking the establishment of a well-designed and well implemented carbon pricing mechanism to transition Australia to a carbon constrained future whilst maintaining investor confidence and security of supply.

In particular, I note that the introduction of this scheme will place pressure on our cash flows, make re-financing of existing debt more difficult, may cause compliance problems with financial services licences and may lower the creditworthiness of the company. We have therefore consistently stated that the scheme must be designed in such a way that:

1. There is appropriate transitional assistance for affected generators to recognise the impact on business value and to ensure a smooth and orderly transition to alternatives or new technologies;
2. That future working capital requirements are recognised;
3. That it provides investment certainty for base load generation to ensure reliability of supply; and
4. That the scheme provides efficient carbon price signals.

I shall speak about the first two points now – while the latter points are covered in the written submission.

Our view is that Clean Energy Future includes positive policy mechanisms but significant risks remain and whilst the scheme will ensure energy security in the short term, it falls short of appropriately compensating generators for business value losses. The inclusion of assistance for the brown coal sector recognises that this critical industry will be hardest hit from the introduction of the carbon scheme. Given the high carbon intensity of brown coal electricity generation, such generators will not be able to pass on the full costs of their emissions.

As currently proposed, the transition arrangements will not sufficiently compensate brown coal generators for the significant cost increases that will be incurred.

Over its whole of life performance, our modelling shows that Loy Yang Power suffers a significant deterioration in business value which may impact the operations of the business in the medium to long term. We are therefore seeking further assistance, but in the event that the level of assistance remains unchanged – consideration should be given to removing the taxation of assistance and remedying the working capital challenge for the industry.

Working capital

The lack of deferred settlement arrangements for permit purchase is the most significant concern that Loy Yang Power has with the legislation as it has wide-ranging impacts on individual generators and the sector as a whole.

Deferred settlement on Government auctions of emissions permits is fundamental to the forward hedging of electricity prices which underpins the viability of the wholesale electricity market, the retail businesses and end users of electricity.

- The purchase of carbon permits will be a significant cost for the stationary energy sector. Based on a Carbon price of $23 per tonne, Loy Yang Power will be required to purchase $450 million in carbon permits each year to enable it to generate at its current output.
- However, Loy Yang Power will also need to purchase future vintages of carbon permits in order to transact forward hedging arrangements; the working capital requirements for Loy Yang Power will be in the hundreds of millions and despite the current level of compensation being offered, will according to our modelling be in the order of one billion dollars by 2025. Clearly, this will be a significant challenge for the business, as it will for many other generators, in fact the Investment Reference Group estimated that about $10 billion in additional working capital will be required under the current proposal. This matter alone may change the dynamics of the hedging market and as a consequence the price of electricity. ACIL Tasman recently completed a modelling exercise on this issue for the esaa and its findings were that without deferred settlement, there could be less hedging of electricity resulting in higher prices and increased volatility. According to ACIL, even a 5 per cent reduction in electricity contracting could result in at least a 10 per cent increase in retail prices in a single year for households and small businesses and up to a 15 per cent increase for large users.

- The lack of deferred settlement arrangements for permit purchase is a significant concern and we would like to see this incorporated into the policy with commencement from 2013 to provide certainty for the industry. It is acknowledged that the Government has attempted to solve this matter through the provision of Government loans; however, it is suggested that many generators may be unable to increase their indebtedness due to existing loan covenants and therefore be unable to access such loans and participate in Government permit auctions without deferred settlement. It should be noted that the previously proposed CPRS had included a deferred settlement mechanism and it is clear that the market and electricity consumers will benefit if this feature is restored.

In summary, forcing generators – who will already be heavily impacted by the carbon price – to pay for future permits upfront will be a massive impost on these companies and an added risk to energy affordability. We urge the Government to consider amending the legislation to ensure permits are paid for by generators in the year they actually emit the carbon.

There are a range of other matters which are of concern and these are outlined in the written submission forwarded earlier. In summary these include:

1. The need for greater volume of permits to be made available at auction
2. Further clarity on the payment of the first cash instalment of the proposed compensation
3. Concerns about the price floor on international permits and
4. The need to adjust taxation of permits such that it is consistent with normal arrangements

Thank you for listening – happy to take your questions.

END OF SPEECH