EUAA ENERGY USERS ASSOCIATION OF AUSTRALIA

AEMC Administered Price Cap Guideline

Submission

April 2009

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1 Introduction and background

1.1 Introduction

This document is the Energy Users Association of Australia (EUAA) submission on the proposed guidelines for compensation requests following the application of an administered price, market suspension, Value of Lost Load (VoLL) or market floor price. The most significant element of compensation discussed in the guidelines relates to events following the application of an administered price. This arises under provisions in the National Electricity Rules for the application of such administered price, if the cumulative spot price over a period exceeds a specified threshold.

This compensation is a potentially significant element of the NEM. Energy users bear the cost of this compensation and so users are concerned about how the compensation is calculated and awarded.

The Energy Users Association of Australia (EUAA) is the national association of electricity and gas users and has over 100 members. This includes many of Australia's largest energy users.

The rest of this submission is set out as follows:

- The next subsection establishes relevant background;
- Section 2 is our understanding of your proposals;
- Section 3 sets out our main concerns.

1.2 Background

Since December 2000, a Cumulative Price Threshhold (CPT) has been established in the National Electricity Rules. When this threshold is exceeded, an administered price of $300/MWh is used for the settlement of the National Electricity Market for each settlement period during which the CPT applies. The CPT is currently set at $150,000. It is calculated over a rolling seven day period, and applies to all settlement periods in which the cumulative prices for all settlement periods over the previous rolling 7 day period exceeds the threshold. It is proposed that the CPT will increase to $187,500 on 1 July 2010.

The CPT was first reached for a brief period in South Australia in March 2008. It has since been reached in both Victoria and South Australia in January 2009, for a significant number of trading intervals in both cases.

The National Electricity Rules provide that dispatched generating units[1] whose dispatch offers are below the administered price cap, are eligible for compensation. The objective of such compensation is to maintain incentives to operate existing capacity, and invest in new capacity.

Compensation will be determined by a 3-person panel according to the guidelines to be developed by the AEMC, and to which this consultation relates. The Rules require the compensation to reflect additional variable costs plus opportunity costs.

The compensation is paid by NEMMCo and recovered from energy users based on the regions in which the compensation was awarded.

2 Our understanding of your proposals

The proposed guidelines describe how direct costs (fuel, operations and maintenance) costs will be calculated. While the calculation of these may be complicated, we expected it would generally be uncontentious, and these direct costs are unlikely to be significant.

For the treatment of opportunity costs, the proposed guidelines distinguish the opportunity cost calculation based on the level of flexibility a generator has to use energy in another period:

- Category (a) claimants are defined to be those that possess a "high degree of flexibility and that have a wide range of choices over when to use their (constrained) energy;
- Category (b) claimants are defined to be those who have a "limited degree" of flexibility.

The proposal is that the opportunity cost for category (a) claimaints is the traded value of cap contracts for a "relevant time period and region"; while that for category (b) will be the difference between the administered price and spot price for a designated period, when the stored energy would otherwise be used.

3 Our main concerns

In this section we set out our main concerns with the proposed guidelines. We start by identifying our more fundamental concerns with the Cumulative Price Threshold. We realise that the CPT is a mechanism established in the Rules and that your consultation is not about this. Nevertheless our view on the appropriate way to determine compensation derives from our views on the CPT. For this reason, we first set out our concern with the CPT.

[1] Other parties are also eligible for compensation but dispatched generating units are likely to be by far the dominant eligible claimants.

3.1 Our concerns with the existence of the CPT

Our main concern about the existence of the CPT is that it has the potential to distort investment signals, by distorting the operation of the energy only market. Capping spot prices will, at least theoretically, be reflected in the prices agreed in swap contracts. Almost all electricity traded on the spot market is hedged through swap contracts of various forms. These swap variable spot prices for fixed prices over various time periods. It is these swap contracts that are the critical variable in investment decisions: they provide the certainty on future prices and revenues. This certainty secures project finance for new projects and hence can be critically important for future investment.

We appreciate that concern about the impact of the CPT has been somewhat academic to-date: since the start of the NEM, the CPT was first reached as recently as March 2008 and even then only briefly. It is therefore reasonable to suppose that in pricing swap contracts, the existence of the CPT is unlikely to have had a meaningful impact on swap contract prices to-date.

However, the events of late January in Victoria and South Australia may be indicative of future trends. The introduction of an emission price and renewable energy policies, could result in a significant change in powerflows around the system. This could mean sustained high price in some areas, in response to supply shortfalls.. In this case, the CPT could in future distort swap prices and hence weaken investment incentives.

The compensation mechanism – even if we assumed that it could deliver compensation equivalent to estimated lost profit – does not allay our concern about the existence of the CPT. This is because the compensation only applies to generators whose offers are greater than the administered price cap. This means that effectively all generation that bids below the price cap only gets paid the administered price cap. Such generation is therefore losing the profit that they would otherwise have earned if prices were not capped.[2]

We realise that our position on this may seem somewhat counter-intuitive: the CPT does, after all, reduce prices from what they otherwise would be. While users would always prefer lower prices, other things being equal, on balance we think that such “gains” could be short-lived and may be expressed over time in reduced investment – and hence less secure supply – and ultimately higher prices in the long run.

Users are also concerned that the integrity of the market should be preserved. If an energy-only market is argued to be appropriate, then it is best that the integrity of this is preserved, rather than distorted through *ad-hoc* administered pricing arrangements, which then spawn complex arrangements for compensation which are meant to address investment and operating incentive problems attributable to those administered price caps.

[2] For contracted electricity generation, the lost profit will be reflected, over time, in contract prices that are lower than they otherwise would be.

In other words, if there is a concern that an energy-only market is not appropriate, then this should result in the development and consideration of alternatives, rather than the application of various *ad-hoc* measures intended to overcome shortcomings in the market. This is a view we have raised in our submission to the AEMC's review of the impact of climate change policies on the energy market frameworks.

Nevertheless, users do have a residual concern that the NEM can be an extremely volatile market and this can result in periods of very high prices, which will ultimately flow through to them in higher prices.

3.2 Our concerns with the proposed guidelines

In light of the discussion above, the over-riding principle that we think should guide the specification of the compensation arrangements, are that these should result in outcomes that would be, as far as possible, similar to those that would result if the CPT did not exist. This accords with the definition of the opportunity costs in the proposed guidelines for category (b) plant. To this extent, we support the proposed guidelines.

However, we are not convinced that the classification of plant into category (a) and (b) is workable:

- How is "a high degree of flexibility" to be defined? While it would be easy to define that such plant should include multi-month storage hydro plant, it is far from clear how apparently run-of-river plant or open cycle gas plant should be treated. To define whether such plant has a high degree of flexibility it would be necessary to examine fuel supply contracts (in the case of OCGT plant) or the impact of cascade hydrology in the case of run-of-river hydro plant;
- The very different compensation arrangements for category (a) and (b) plant is likely to result in strong incentives on generators to argue that their plant is category (b).

We are also concerned about the definition of the opportunity cost of category (a) plant. In particular, how is a contract to be chosen for which the "traded value" is meant to represent the foregone revenues? In addition, this approach assumes that all generation is contracted. This is arguable, not least because plant in category (b) is implicitly assumed not to be contracted.

More generally, we think that the statistical basis for arguing that the opportunity cost for plant with a high degree of flexibility is *necessarily* different to that for plant with less flexibility, is probably not sustainable.

For these reasons we think that the proposed classification of claimants into two categories, and with different specifications of opportunity costs, is likely to be neither workable nor theoretically robust.

While we can understand the AEMC's desire to limit flexibility on the calculation of opportunity cost, in order to attempt to ensure consistent decisions made by the panel, we do not think that narrow guidelines are workable.

Our suggestion is that compensation claimants should be free to propose whatever calculation of opportunity cost they like, subject to the condition that it should satisfy the objectives in the Rules that compensation should provide investment and operating incentives.

We suggest in addition that the guidelines could usefully prescribe some factors that should govern the decisions of the three-person panel. Two factors that we suggest should be included in the guidelines are that:

- Decisions on compensation by the panel must be unanimous;
- The level of compensation approved should be "beyond reasonable doubt". This establishes a sufficiently high burden of proof to ensure that spurious opportunity cost claims are not successful.

The main advantage of this approach is that it will be simpler to administer and it avoids unnecessary debate on whether or not a claimant is in category (a) or (b) and if so what the opportunity cost should be in either case.