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EnergyAustralia™
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17 January 2008

Dr John Tamblyn
Commissioner
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email: submissions@aemc.gov.au

Dear John,

Review of the Schedule of the Administered Price Cap

EnergyAustralia welcomes the opportunity to provide comments on the review of the schedule of the Administered Price Cap **(APC)**.

The policy objective of the APC

The Cumulative Price Threshold **(CPT)** and the APC are important components of the National Electricity Market **(NEM)** safety net, which when triggered, operates to limit participants' exposure to the wholesale spot market during periods of prolonged high prices (essentially market failure). As the market is quite volatile such sustained high prices can result from both normal and abnormal market conditions, and without these provisions the market would experience substantial financial stress (and potentially collapse).

EnergyAustralia believes the policy objective of the APC should be to balance the overall financial risk to market participants in times of extreme market conditions, while maintaining appropriate incentives on individuals for prudent risk management and for minimising distortion of incentives for efficient investments. The APC however, should not be seen as a mechanism for generators to obtain opportunistic return on their capital investments.

EnergyAustralia believes the current level of the CPT allows generators plenty of upside from extreme market circumstances prior to the commencement of an administered price period **(APP)** and provides all generators with the ability to make an adequate return on their investments. EnergyAustralia also believes the price signals seen in the market in the events

Partner

leading up to the triggering of the CPT are sufficient to promote efficient investment in the NEM[1].

The level of the APC given the above criteria and policy objective

EnergyAustralia believes that the current level of the APC ($100/MWh between 7.00am and 11.00pm on business days (peak); and $50/MWh at other times (off-peak)) is appropriate and effective in balancing the overall financial risks to market participants during extreme market events.

EnergyAustralia believes that raising the APC to $500/MWh during the peak period and $100/MWh during the off-peak period, as suggested by some market participants would not be in the greater good of the market. EnergyAustralia believes any substantial increase in the APC may not only lead to increased financial stress for customers and Retailers, but it would also create the possibility of long lasting consequences for the balance within the NEM in the generation landscape. SnowyHydro for example is well known within market circles to actively sell caps, an integral part of the system security to the NEM. A prolonged period where prices were artificially kept high would endanger the viability of the NEM going forward as it would seriously impinge on SnowyHydro's, and any other cap seller's, financial viability.

Although EnergyAustralia's position is not to increase the APC, we do however believe there may be some merit in considering a minor increase, say to a maximum of $120/MWh for the peak and the off-peak period as a possible alternative to reflect the current marginal cost of gas fired generation.

Gas fired generation arguably has a marginal fuel cost of approximately $50/MWh. A price of $120/MWh for both peak and off-peak may help ensure that there is incentive for gas fired generators (where required) to operate, while at the same time not exposing cap sellers and future system security. Where this is not the case, clause 3.14.6 of the National Electricity Rules **(NER)** allows dispatched generators with offer prices higher than the APC to claim for compensation when the APC and floor are in operation.

EnergyAustralia believes it would be inappropriate to set the price any higher than $120/MWh for both peak and off-peak for the following reasons:

1. It would more than likely over-compensate most generators in the vast majority of cases;
2. Should there be price stresses in the short-term gas market as seen in the winter of 2007 a price cap of in the vicinity of even $500/MWh in peak periods would still be insufficient. The ability for generators to claim compensation under clause 3.14.6 of the NER is arguably a better mechanism;

[1] For example, a peaking generator in NSW could have earned around $80/kW contribution towards its fixed costs in the winter of 2007, although price levels were insufficient to trigger the CPT. In the event that a market disturbance has been taking place for a longer period than this – albeit without creating price levels sufficient to trigger the CPT – earnings may be much higher than this.

3. It may lead to later system security issues by causing undue and irrevocable financial duress on cap sellers; and
4. Price setting at high levels does not pay heed to new technological advances which may lead and/or displace the current preferred new generation of gas fired plant. In this instance an immediate lift towards $500/MWh would be viewed by EnergyAustralia as ill-considered.

Ability to seek compensation

As the Australian Energy Market Commission **(AEMC)** is aware, EnergyAustralia on 10 December 2007 submitted in accordance with s.91 of the *National Electricity Law* **(NEL)** a request to make a Rule change to the current compensation provisions. The objective of the rule change proposal is to ensure that compensation to generators during an APP is based on their direct generating costs, rather than on their offer prices. The proposed rule change clarifies the roles of the AEMC and the expert panel, and the factors that must be taken into account, in relation to both the threshold question as to whether compensation is to be awarded and the determination of a fair and reasonable amount. It also proposes a consultation process, whereby the AEMC must publish and receive submissions on a draft expert panel report and take these submissions into account when making its determination.

EnergyAustralia's proposed rule change removes much of the uncertainty over the criteria for determining compensation, by making it clear that the objective of the compensation is to ensure that a dispatched generator is able to recover its direct generating costs during periods of capped spot prices. It also better delineates between the two tasks of deciding whether compensation should be awarded and determining the compensation amount.

EnergyAustralia believes its proposed rule change will deliver substantial economic benefits to the market and will address a number of concerns already raised by other market participants regarding how the compensation provisions will operate following and APP.

AEMC Reliability Panel Comprehensive Reliability Review

In its submissions to the AEMC Reliability Panel Comprehensive Reliability Review **(CRR)**[2] EnergyAustralia advocated that the current level of the CPT cuts in too late and therefore the threshold does not remain faithful to its principle of offering protection in the event of extreme system stress. This remains our position. Despite the existence of a number of episodes of extreme market events, the CPT has still not been triggered since its introduction.

EnergyAustralia believes the conclusions reached by the AEMC Reliability Panel **(Panel)** in its CRR Final Report (dated December 2007) to raise the level of the Value of Lost Load **(VoLL)** in the medium term to $12, 500, effective 1 July 2010 and the CPT to $187,500 will only increase the risks faced by market participants and may translate into generally higher prices to end-use customers in order to manage this additional exposure.

[2] Submission to the Second Interim Report (letter dated 28 September 2007), Interim Report (letter dated 17 May 2007) and Issues Paper (letter dated 30 June 2006).

In June 2007 the NEM experienced what EnergyAustralia believes to be a form of market failure when the retailer of last resort **(ROLR)** arrangements were invoked following the suspension of Energy One from the NEM. Although this was not a physical failure of the NEM, it did however materially adversely affect a number of customers and resulted in the lessening of retail competition in the NEM. Given the Panel's proposal to raise VoLL and the CPT, further participants may also be forced to exist the NEM in the future.

The Panel's recommendation to increase the CPT will provide further opportunities to signal efficient generation investment and therefore further supports EnergyAustralia's position that additional upside during an APP event is not appropriate. Furthermore, a prudent generator will largely hedge its spot price exposure by selling hedging contracts. For example, a peaking generator will sell cap contracts, under which it is guaranteed to receive the fees from sales of these contracts, irrespective of the spot price outcomes. In a balanced generation market, these fees should be sufficient to cover a peaking generator's fixed costs and so will ensure that these costs continue to be covered in the lead up to and during an APP.

In summary EnergyAustralia believes the ultimate policy objective of the APC should be to limit the financial stress on the market during extreme conditions (essentially market failure). EnergyAustralia therefore recommends the schedule for the APC should not be increased from its current level.

Should you require any further information or have any questions relating to this submission, please do not hesitate to contact Philip Dixon-Flint, Regulatory Strategy Manager Wholesale on 02 9269 2317.

Yours sincerely,

Mike Bailey
Executive General Manager Retail