

1 September 2022

Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Electronic submission

Dear Sirs,

National Electricity Amendment (Amending the Administered Price Cap) Rule

Snowy Hydro welcomes the opportunity to comment on the matters raised in the Consultation paper from the Australian Energy Market Commission on the National Electricity Amendment (Amending the Administered Price Cap) Rule ("Rule Change Request").

The purpose of this submission is to respond to the substantive issues raised in the consultation paper, and follows our previous submission in relation to the proposed treatment of the Rule Change Request under an expedited process.¹

Snowy Hydro agrees that the Administered Price Cap should be increased. For the reasons stated by the proponent and the Commission, it is suboptimal for the APC to be lower than the short run marginal cost of operating of coal assets and open cycle gas turbines.

Based on current traded thermal fuel costs, we agree that \$600/MWh would be an appropriate level for the APC, although we consider that alternative formulations, such as an APC linked to the traded price of gas or alternatively a multiple of the spot price, should also be assessed. Ideally, the level and operation of the APC would be reviewed together with the related issues of generator compensation and market suspension. Snowy Hydro is considering initiating a rule change proposal which would allow for a comprehensive assessment of these issues following the conclusion of the current compensation processes.

While Snowy Hydro agrees that the APC should be increased, we consider that an increase should be phased in to allow parties to adjust their contract positions. Taking into account the tenure of current contracts, any change to the APC should not take effect until 1 January 2025. Implementing a change to the APC on a short-term basis, without a transition period, would expose systemically important generators - those such as Snowy Hydro who provide an irreplaceable insurance function for the market - to potentially intolerable financial risk. Such an outcome cannot be reconciled with the National Energy Objective.

Generator Contracting Strategies and Risks

The contracts market is critical to the efficient functioning of the NEM, and it follows that this proposal must be considered in light of its impacts on that market. The consultation paper, however, does not sufficiently acknowledge these impacts, merely repeating the proponent's elliptical remarks:

¹ Snowy Hydro submission dated 17 August 2022

There would be expected impacts to existing exchange traded and OTC contracts, and there would also be implications for future contract structures. This may have a bearing on risks for generators and energy users and the incentives for market participants to offer and purchase energy derivatives.....

There may be impacts on exchange traded and OTC cap contracts that are generally based on a \$300 price. Changing the value of the APC changes the exposure of sellers under caps and the value of the product.

Changing the APC may create uncertainty in the OTC market, for example in relation to market disruption clauses, which can include material change formulas related to the specified price.

For a generator which has pre-sold its output under contracts, the impact of the Rule Change Proposal on its existing contract portfolio is not merely a side-issue that can be assessed in isolation from its impacts on spot market efficiency. It is no exaggeration to say that, for generators which are fuel-constrained, an immediate change to the APC risks threatening their commercial viability.

Generators entered into existing contracts on the basis of the current APC. This is particularly relevant for sellers of the dominant form capacity contract - the cap contract with a strike price of \$300/MWh or '\$300 cap'. Whatever the historical reasons for setting the APC at its current level, if the APC had been different at the time at which existing \$300 caps were sold, or if there was a reasonable prospect that the APC would be increased on an expedited basis, as contemplated in the Rule Change Request, generators' (and retailers') contracting strategies would have been different.

The level of the APC is a critical input for the contracting strategies of fuel-constrained generators, because, together with the Cumulative Price Threshold (CPT), it provides a backstop against excessive fuel drawdown during periods of market volatility. That is, generators sold \$300 caps in the knowledge that should extended volatility arise, the level of the APC means that they would not be required to generate when the CPT is triggered, because the strike price of the sold caps is the same as the APC. However, increasing the APC from \$300/MWh to \$600/MWh implies an increase in the amount of fuel needed to defend existing \$300 caps contracts. If additional fuel cannot be sourced - and this is usually impossible for hydro generators - they will be exposed to potentially ruinous unfunded difference payments under derivative contracts.

Stated another way, contracting parties are entitled to rely on the protection of the APC. That indeed is why it exists, to protect the financial integrity of market participants. Increasing the APC before the expiry of those contracts is tantamount to a retrospective change.

Impact on the NEM

Without an appropriate transition period, this change could cause real damage to the NEM. Fuel-constrained generators would face an invidious choice when the CPT is triggered: run down scarce fuel reserves and, when they can no longer do so, use their balance sheet, to defend contract positions, depriving themselves and the market of their peaking capacity during later periods, or desperately attempt to buy back positions,

which will either be impossible by the time at which the APC binds or will only be possible at uneconomic prices. Both outcomes are highly unfavourable for the NEM.

It is also important to acknowledge that increasing the APC would not have solved or prevented the NEM's energy crisis, which was fundamentally related to a shortfall in energy. Increasing the APC does not alter the physical supply capability of the NEM fleet.

Impact on the Contracts Market

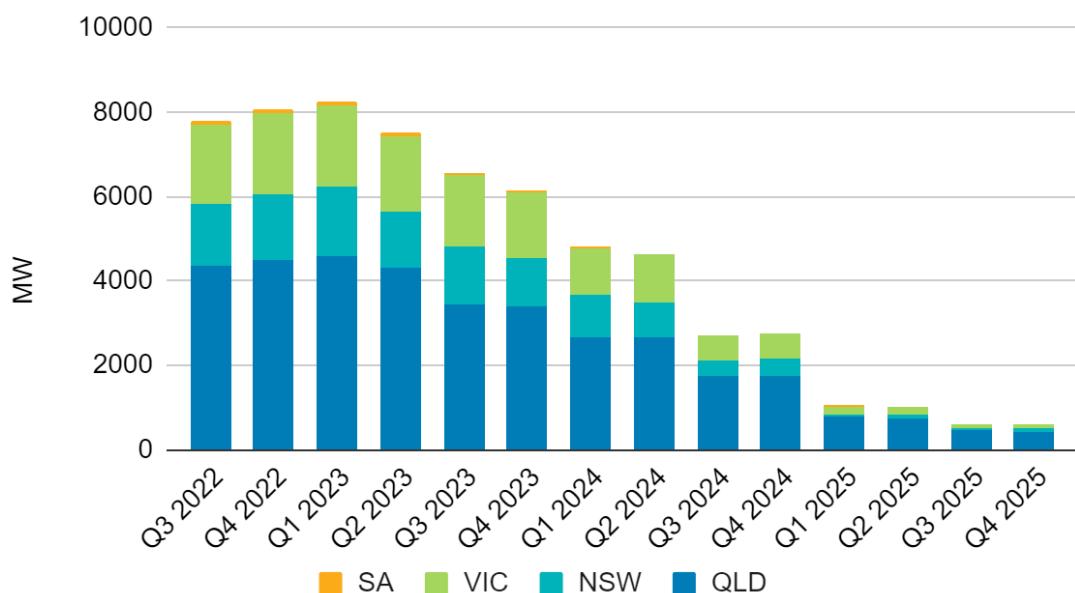
An immediate increase in the APC would also distort the purpose of \$300 caps, creating unintended winners and losers. Needless to say, \$300 caps are intended as a capacity contract. Yet the additional generation implied by increasing the APC while existing \$300 caps are on-foot and while fuel prices remain elevated effectively forces the sellers of those caps to generate for energy, rather than capacity. Buyers under existing \$300 caps would enjoy a financial windfall at sellers' expense, and the value of those caps would rise significantly as they offer relatively superior protection during periods when the CPT is triggered. This may encourage buyers of caps to realise this additional value by liquidating their contract positions.

This change would also have long-term impacts on the contracts market. The importance of a well-functioning secondary market to the operation of the primary market, the NEM, cannot be overstated. This is highlighted in recent regulatory reforms which attempt to improve contract availability and liquidity.² Yet without a transition period, this Rule Change Request would reduce liquidity in the contracts market. Fuel-constrained generators in particular would be less inclined to sell capacity through the exchange traded market - in general, regulators' preferred marketplace given the increased visibility of participant positions - as it relies on standardised contracts, and does not allow parties to implement a variable strike price. Again, this would be a serious downside of increasing the APC while current contracts remain on-foot.

We note that the tenor of existing exchange traded contracts is between 2 and 3 years, as shown below in the chart of open interest for \$300 caps on the ASX energy market. As of 26th August 2022, there are material volumes of contracts outstanding in Qld, NSW and VIC for all quarters from Q3 2022 to Q4 2024. An abrupt increase to the APC for any period up to Q4 2024 would modify the payoff structure for these sold contracts and effectively represent a retrospective change to the contract market during that period.

² For example, the Market Liquidity Obligation.

ASX Cap (\$300/MWh Strike) Open Interest, 26th August 2022



In summary, Snowy Hydro confirms its support for increasing the level of the APC, but we reiterate the need for this change to be phased in, so that it takes effect no earlier than Q1, 2025. We note that the timing of changes recommended by the Reliability Panel in its reviews of market price settings typically takes place a number of years in advance of the review period, in order to allow participants time to adjust to any changes (as indeed is the case with current review). The same consideration should apply to this Rule Change Request.

It is also essential that the Commission weighs up the function and role played by the generators who will be most affected by this proposal. We acknowledge that there are a number of generators who would stand to benefit from an immediate increase in the level of the APC, but they are more likely to be providers of bulk energy, not sellers of insurance products upon which the NEM depends as generators of last resort - the parties who, by definition, are most needed by the market during the periods when the APC applies. Without a transition period, increasing the APC will expose fuel-constrained generators to severe financial risks, undermining the financial viability of those generators and by extension risking severe damage to the NEM.

Yours sincerely,

Leigh Creswell

Leigh Creswell

Snowy Hydro Limited