22 June 2023

Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Electronic Submission

National Electricity Amendment (Amendment of the Market Price Cap, Cumulative Price Threshold and Administered Price Cap) Rule Change

Snowy Hydro welcomes the opportunity to comment on the matters raised in the National Electricity Amendment (Amendment of the Market Price Cap, Cumulative Price Threshold and Administered Price Cap) Rule Change (Consultation Paper).

1. The Market Price Cap (MPC) and Cumulative Price Threshold (CPT)

Snowy Hydro agrees with the Reliability Panel that the existing levels of the MPC and CPT are too low to support marginal new entrant investment in the National Electricity Market (NEM), particularly for firming and storage. Snowy Hydro therefore supports the proposed increases to these settings; this will shore up system security and deliver the best outcomes for consumers.

Snowy Hydro further agrees with modelling conducted by the Reliability Panel, which suggests that "maintaining existing levels of the MPC/CPT may, in the absence of additional jurisdictional or AEMO intervention, lead to an increase in USE and uncertainty for consumers associated with insufficient investment outcomes."[1] Retaining the status quo would contribute to underinvestment in the NEM, requiring increased use of expensive out-of-market mechanisms, such as AEMO's Reliability and Emergency Reserve Trader (RERT) function to maintain reliability. The cost of the RERT is ultimately recovered from energy consumers.

Pricing outcomes for capacity hedging instruments support the need to increase the levels of MPC and CPT. In an efficient market, the price of a $500 Cap, which serves as a proxy for capacity cover in the NEM, should converge at or near the new entrant price (NEP), which represents the cost of self-insurance by Market Customers (ie. the cost building dispatchable capacity). However, until recently in most NEM jurisdictions, the traded price of Cap contracts was well below the NEP. Cap contract premiums are still below NEP in Victoria.

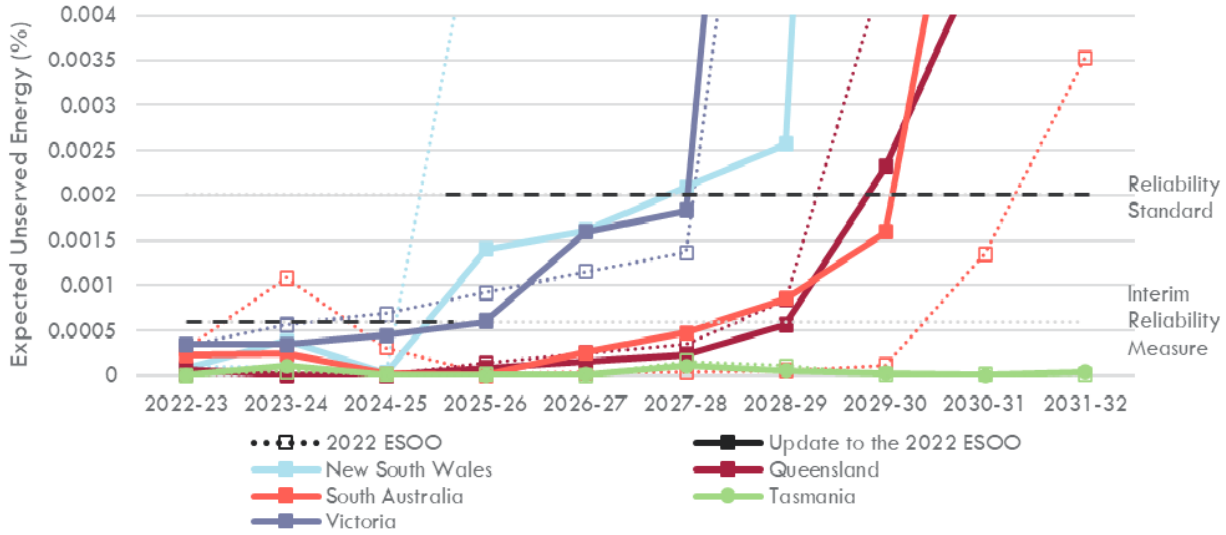
The underpricing of cap contracts can be attributed to a significant extent to the influence of market settings, which has encouraged excessive risk taking by NEM-exposed counterparties. Some participants appear to have relied on market settings or central intervention to manage their exposure to volatility, as an alternative to purchasing a sufficient level hedging cover. This has had damaging but predictable

[1] Reliability Panel, *Draft Report, 2022 Review of the Reliability Standard and Settings*, 9 June 2022, p64

outcomes for system security; lack of revenue adequacy for and, ultimately, underinvestment in dispatchable assets. The grim consequences of underinvestment and under-hedging became apparent during the 2022 energy crisis.

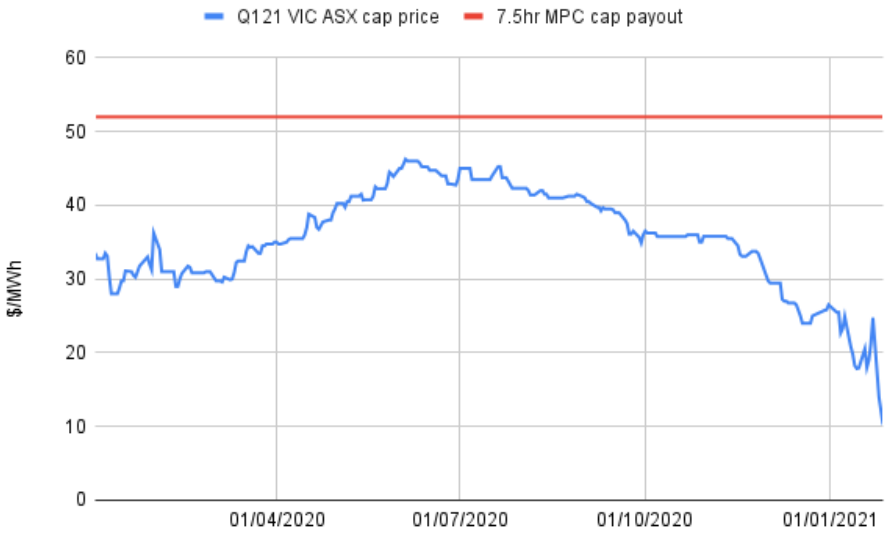
This phenomenon is concerning because securing the level of investment needed to manage the transition is the single most important challenge for the energy market. The scale of the challenge was highlighted in AEMO's February 2023 update to the 2022 Integrated System Plan, which forecast exceedances of the reliability standard in all NEM regions. The key point is that in an energy-only market, the principal, the most cost-effective and only sustainable lever to increase investment is to increase in-market revenue incentives. As described in section 3 below, suppressing market settings below optimal levels does not reduce the cost of supply, it merely transfers costs to less efficient, out-of-market sources.

Figure 1 **Reliability and indicative reliability forecasts, all regions, 2022-23 to 2031-32**



In its submission to the Reliability Panel last year, Snowy Hydro analysed the cost of Q1 $300/MWh traded caps in Victoria, together with a payout for a CPT event based on 7.5 hours of pricing at the MPC, which equates to approximately $52/MWh on a quarterly basis. This analysis indicated Market Customers were buying cap coverage up to, but not more than, the level of protection offered by these settings. This supports the argument that existing levels of MPC and CPT have had a dampening effect on new investment, contributing to a lack of system reliability. This should be addressed in order to improve energy market outcomes, but also on the grounds of fairness, insofar as it represents a form of moral hazard. It suggests that the current levels of CPT and MPC encourage under-hedging by market participants, who profit from avoiding energy market costs and effectively transferring those costs to others.

Q1 2021 Vic Cap Price vs 7.5 MPC Cap Payout



Reflexive opposition to increases to the MPC and CPT on the basis it would increase energy costs is misplaced. As stated by the Reliability Panel, "a significant increase in the MPC and CPT doesn't automatically cause a material increase in consumer bills as the costs associated with high price periods are still small when compared to the costs across the rest of the year".[2] The cost of energy, rather than capacity, is a much more significant influence on consumer electricity costs.

2. The level of the Administered Price Cap

The APC plays an important role in maintaining the stability of the NEM and market protecting participants from sustained periods of volatility. The proposed changes to the MPC and CPT contemplated in the Consultation Paper means it is appropriate to consider the level of the APC.

The relationship between the MPC, CPT and APC - that is, the relativity between the settings - is often overlooked. In particular, the level of the MPC is an input into the CPT, and thus the protection offered by the APC is, by definition, influenced by changes to the MPC. The particular issue is that the current approach, whereby the APC is set as a static number while the MPC is indexed, tends to create an increasing relative financial exposure for participants before the APC is triggered. This divergence may create an incentive for non-fuel constrained generators with transient market power to hold the spot price significantly above the APC but just below the price which would trigger the CPT. This risk is exacerbated by the increasing incidence of supply driven market volatility events, given the increasing penetration of weather-dependent renewable generation This deprives participants from receiving the protection of the APC in circumstances where they otherwise would and constrains the ability of other generators, particularly those with fuel constraints, from offering hedges. This undermines the purpose of the APC and is inconsistent with the National Energy Objective.

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[2] Reliability Panel, *Draft Report, 2022 Review of the Reliability Standard and Settings*, 9 June 2022, p64.

An appropriate way to address this issue would be to link the level of the APC to the MPC. Snowy Hydro proposes setting the APC as an amount equal to 4% of the MPC, as a predictable way to maintain the relativity between these settings. Although the Commission has stated that it is not intending to consider indexation arrangements for the APC in this rule change (given the Reliability Panel's review of the form of the Reliability Standard and the APC) distinguishing the level from the form of the APC is to create an artificial distinction. Snowy Hydro considers, therefore, that this rule change remains a legitimate and appropriate place to consider a proposal of this kind.

If, however, the AEMC does not wish to consider linking the APC to the MPC in this rule change, an alternative approach to maintain the relativity between the two settings is to adjust the APC over the review period. In particular, Snowy Hydro suggests the following adjustments to the APC, in order to take account of the recommended increases in the MPC:

Financial Year	**Proposed APC**
FY25	$500/MWh
FY26	$600/MWh
FY27	$700/MWh
FY28	$800/MWh

Adjusting the APC for the 2025 financial year would mean a change earlier than is contemplated in the Consultation Paper (ie. from 1 July 2024, rather than 1 July 2025). There is, however, a compelling case to do so, as it would partly ameliorate the hardship caused by the AEMC's decision in 2022 to immediately double the APC to $600/MWh. That increase in the APC created severe risks for Snowy Hydro and other fuel constrained generators, who had pre-sold hedging cover (ie. $300 Caps) on the basis of the then $300/MWh APC. It exposed sellers of $300 Caps to unrecoverable energy losses should sustained market volatility occur, and this risk remains while cap contracts struck prior to the decision remain on foot.

Given typical OTC contract tenure, $300 cap contracts struck prior to 2022 will have largely expired by the end of FY25. It is therefore appropriate to provide some relief in the APC for FY25 and adjust the APC to maintain consistency with the CPT from FY26 onwards. This will encourage the supply of hedging contracts by fuel-constrained generators, in that there will be a known price path for the APC, and the combination of settings for the MPC, CPT and APC will continue to provide a measure of protection against prolonged high spot pricing.

3. Decision Making Framework and Considerations

The Consultation Paper acknowledges the role of jurisdictional schemes as a way to improve system reliability. While they are important policy measures [and supported by

Snowy Hydro], they do not detract from the need to improve in-market incentives to ensure investment consistent with the reliability standard. As stated in the Consultation Paper, those schemes may provide some revenue certainty for new investment. However, as currently designed, they will not be at a scale, and have not been designed to, provide revenue sufficiency for firming and storage assets in aggregate across the NEM. They will not provide revenue support for existing dispatchable assets.

The previously proposed 'capacity mechanism' could have been designed with sufficient breadth such that it served as an alternative to in-market capacity revenues. If it had done so (and been implemented), it would have changed the NEM into a capacity market. However, that mechanism has been abandoned and the NEM remains an energy-only market. Accordingly, as stated above, the MPC and CPT remain the principal and only sustainable levers to improve investment in the NEM.

Deferring much needed increases in market settings on the basis of relatively narrow and still-in-development jurisdictional schemes would risk underinvestment. It would also discriminate against owners of existing generation plant, who would be unable to access revenue support for those assets. They would be exposed to 'missing money'. The development of jurisdictional schemes does not, therefore, serve as a reason to not adopt the recommended adjustments to the MPC or CPT.

Finally, in considering whether or not to adopt the proposed reliability settings, the AEMC must consider the counterfactual. If in-market revenues are not permitted to adjust to an appropriate level, then revenue support for generation must, by definition, be sourced out-of-market. However the evidence to date in the NEM and elsewhere suggests generation procured and funded out-of-market, such as through the RERT, is significantly more expensive for consumers. Transferring generator revenue support from in-market to out-of-market sources does not reduce the cost of supply. In fact, because it would avoid these higher costs, an increase in the market settings is the most cost-effective way to improve system reliability.

Snowy Hydro appreciates the opportunity to respond to the AEMC on this matter.