26 October 2023

Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Electronic Submission

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

Snowy Hydro welcomes the opportunity to comment on the Draft Rule Determination for the National Electricity Amendment (Amendment of the Market Price Cap, Cumulative Price Threshold and Administered Price Cap) Rule (Draft Determination).

Proposed Changes to the Market Price Cap (MPC) and Cumulative Price Threshold (CPT)

Snowy Hydro supports the proposed changes to the MPC and CPT set out in the Draft Determination. The changes will encourage investment in generation capacity, particularly firming and storage, which will be essential to maintaining system reliability during the transition.

As explained in our submission to the consultation paper, in an energy-only market such as the NEM, reliability settings form the key investment signal for both existing and new generation capacity. The transmission channel through which reliability settings incentivise investment in generations assets is the contracts market. Market Customers exposed to the spot market purchase forward contract cover to hedge their exposure to spot market volatility. Revenue earned by generators through the sale of hedges underwrites long-term investment in generation assets. The spot market is unable to play this role because it does not provide the revenue certainty or stability over a sufficient period to finance investment in new assets. In Snowy Hydro's view, therefore, the contract market is equally, if not more important, than the spot market for long-term system reliability. It should be given commensurate weight by policymakers when assessing rule change proposals.

Reliability Settings which are too low will not deliver the revenue sufficiency required for new investment. It also encourages underhedging by Market Customers, a form of moral hazard. In this respect we agree with the IES RSS review commissioned by the AEMC:

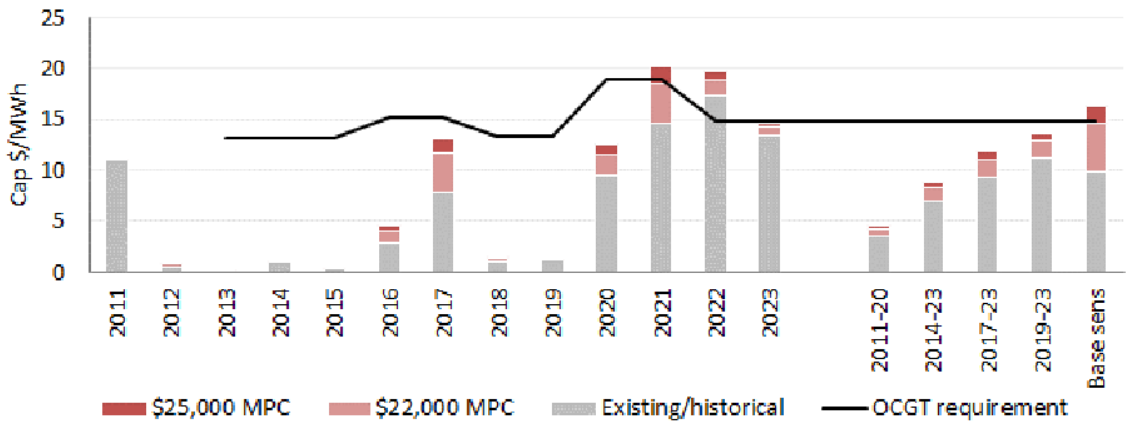
> *Within the existing framework, volatility in spot outcomes is necessary to foster a functioning contracts market. Increased volatility, under equivalent conditions, correspondingly motivates both power generators and retailers to actively hedge its exposure to provide revenue and cost certainty.*[1]

[1] p52

Not only is spot market volatility critical to the contracts market, but, because of the investment transmission channel mentioned above, it is ultimately critical to the functioning of the NEM itself. It follows that reducing spot market volatility by limiting reliability settings below efficient levels will undermine both the spot and contract markets and, ultimately, the ability to maintain a secure and reliable energy supply.

Figure 38 of the IES analysis (below) highlights that market settings have been depressed below new entrant OCGT revenue requirements in NSW for some time. The reason that system security has been maintained despite a sustained period of missing money is that the NEM had, historically, an abundant supply of coal generation assets. The market remained secure by relying on the historical overinvestment in coal generations by publicly-owned utilities. As those coal assets retire, the NEM will not be able to adopt this approach in future. New investment, particularly in capacity and storage, will be required. AEMO's 2023 Electricity Statement of Opportunities highlighted the pressing need for such investment.

Figure 38 Cap settlement values (NSW)



Given the decline of the coal fleet, the only means to maintain reliability in the NEM without increasing MPC/CPT would be to rely on resources procured out of market, such as through AEMO's Reliability and Emergency Reserve Trader (RERT) function. The cost of RERT usage demonstrates it is a much more expensive way of maintaining reliability as compared to using in-market capacity.[2] This is consistent with the AEMC's finding in the draft determination that maintaining the MPC/CPT at existing levels would result in higher long-term energy costs for consumers compared to the proposed changes.

Proposed Change to the Administered Price Cap (APC)

The AEMC appears to proceed on the basis that the only significant consideration when determining the level of the APC is that it should be sufficient to cover the short-run marginal cost of generators. The decision to immediately increase the APC to $600/MWh in 2022, and the proposal in the Draft Determination to retain an APC of $600/MWh, is consistent with this approach. However, the AEMC has not recognised

[2] RERT resources have been procured and dispatched by AEMO at prices exceeding $60,000/MWh.

that using this as the basis for determining the level of the APC created a new, serious problem for fuel-constrained generators. In particular, the AEMC has not considered the impact of changes to the APC on the contracts market.

Fuel-constrained generators who forward sell contracts (and indeed who may be under a legal obligation to do so[3]) face the obvious risk that they may exhaust the fuel reserves needed to defend their contract exposure. This risk is managed by limiting the volume of energy pre-sold and, to the extent reasonably possible, relying on the market structure that is in place at the time when contracts are executed. When significant changes are made to the NEM during a current contract period (typically up to 3-4 years in duration), the value and the risk profile of existing contracts can change radically. The increase in the APC is a singular example of such a change.

Whereas fuel-constrained generators deliberately set cap strike prices at the same level as the APC as a means to manage their fuel constraint (ie. $300/MWh), the immediate doubling of the APC created a large divergence between cap strikes and the level of the APC. This decision exposed forward-contracted fuel-constrained generators, through no fault of their own, to volumes of pre-sold energy that they may have no physical means of supplying. In other words, AEMC's decision created a de facto obligation to supply potentially large volumes of energy where none had previously existed. That may not be a problem for thermal generators but it caused genuine hardship for generators subject to fuel constraints.

Hydro generation assets, needless to say, depend on water reserves. Such reserves are a natural phenomenon. Snowy Hydro cannot procure external sources of water for generation. Therefore, when the APC was increased while current contracts are on-foot, Snowy Hydro was exposed to a radically higher degree of risk. This is damaging not simply to Snowy Hydro but to the NEM as a whole, because the price and availability of hedging cover is critical to a competitive market. To a large extent, contracting arrangements determine spot market outcomes.

Take the following example to illustrate the financial risk created by the increase in the APC. Prior to the doubling of the APC, during a period of extended volatility the financial exposure of a large fuel-constrained generator that had pre-sold a 500MW, $300 Cap would be nil after the Cumulative Price Threshold is triggered (ie. following 7.5 hours at the MPC). Following the doubling of the APC, the financial exposure of the same generator under that contract would, from the time administered pricing applies, increase from nil (under a $300/MWh APC) to $3.6m per day (ie. [$600-$300] x 500 x 24) (under a $600/MWh APC). If administered pricing persisted for 67 hours, as was the case during the 2022 energy crisis, its financial exposure would be $10,050,000 - under a single contract during one period of volatility. If the generator cannot earn the spot revenues needed to defend this contract exposure, because it cannot meet the increased fuel requirements, it could face solvency challenges. This demonstrates the danger of rapid changes to the market structure that do not consider the impact on contracted participants.

[3] Under the Market Liquidity Obligation

Given that the AEMC accepts the importance of the contracts market in the NEM, as well as the importance of reliability settings to the effective functioning of that market, it is inconsistent to ignore the impact of changing the APC on contracted participants.

As stated in our previous submission, Snowy Hydro, in fact, supports a higher APC - provided that it is implemented with adequate notice, so that participants have time to adjust their contracting arrangements. Furthermore, for the reasons set out in that submission, Snowy Hydro considers that the APC should be linked to the MPC. Such an approach is within scope for the AEMC to consider in this rule change and we request again that it be considered by the AEMC in its final determination.

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