Project Team
Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Submitted online: https://www.aemc.gov.au/contact-us/lodge-submission

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Review into Electricity Compensation Frameworks

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission in response to the Australian Energy Market Commissions ('AEMC') *Review into Electricity Compensation Frameworks* Consultation Paper.

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

In the two years since the June 2022 market suspension, there has been continued uncertainty around the administration of the compensation regime. It is crucial to understand the underlying causes that led to the market suspension when considering regulatory reform.

The AEC welcomes this review undertaken by the AEMC. There is an opportunity for reform that would help provide confidence to market participants and support better outcomes for customers. The AEC believes that any reform should be undertaken based on providing clarity, consistency and timeliness to the compensation regime, remain fixed in market-based principles and focus on preserving commercial decision-making to the greatest extent possible. Fundamentally, an appropriate compensation regime is necessary for the NEM to function smoothly at times of market stress to the ultimate benefit of energy consumers.

Chapter 3

Question 1: Assessment Framework

Are there any other relevant considerations or principles that should be included in the assessment framework?

The AEC supports the assessment framework set out in the AEMC Consultation Paper. The review into compensation frameworks is timely and must provide confidence to market participants and support better outcomes for consumers.

It is critical that any regulatory reform measures first understand the underlying causes of the issues that led to the market suspension. Likewise, the focus of any reforms should be market-based, preserving commercial decision-making to the greatest extent possible.

Chapter 4

Question 2: Objectives

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

1. *Do stakeholders have any proposed changes to the objectives of the various compensation frameworks?*
2. *Is the reasoning behind each objective still appropriate and relevant?*
3. *Regarding the directions compensation framework, how do we best balance the need to avoid creating a perverse incentive to be directed with the objective of compensating directed participants fairly? How well is this achieved under the current framework?*

The AEC agrees with the AEMC's approach which is to review whether the frameworks provide adequate incentives for participants to provide services. Market participants should be confident that they will be no worse off financially from supplying additional energy if required by AEMO regardless of market circumstances, and that compensation is paid in a timely and predictable manner.

We do not think the objectives of the compensation frameworks are deficient, but rather with the compensation regime itself and the underlying incentives it creates. The focus should therefore be on these elements, taking a market-based approach that preserves commercial drivers to the maximum extent possible.

We suggest that there be a single objective across all three frameworks as ultimately the purpose of all is to maintain the incentives for generators to make supply available in the market during times of market stress.

Regarding the directions compensation framework, the AEC does not agree that there is a perverse incentive to be directed. As it stands, clause 3.9.7(b) of the National Electricity Rules (NER) precludes generators constrained on from receiving compensation due to its spot price being less than its dispatch offer price. This has the effect of leading generators, concerned that they might be constrained on, to choose to bid as unavailable to potentially avoid running at a loss that being constrained on entails. Should generators subsequently be directed to operate, they are able to receive compensation. We believe that there are amendments to the NER that can be made to remove the issue of generators having little choice but to bid as unavailable. Specifically, the AEC suggests that modifying clause 3.9.7(b), through the addition of a new sub-clause for instance, to allow for compensation for constrained on participants dispatched for essential system services, or other reasons, to receive compensation, would severely reduce the need for directions for system strength. Additionally, alterations can be made to clause 3.15.7B can be made as to allow directed participants constrained on to apply for compensation for opportunity costs.

Question 3: Achieving the Objectives

1. *Do stakeholders agree with the observation that the administered pricing and market suspension compensation objectives may not have been achieved in the June 2022 events?*

2. *If directions compensation was preferred to the other frameworks, were there any specific reasons why this was the case?*

The June 2022 market events were primarily a result of the Administered Price Cap (APC) of $300/MWh being far below what was needed in the market given the prevailing commodity prices. This drove much of the behaviour seen in the market at the time. The $300/MWh APC was misaligned with the APC in gas markets of $40/GJ, which translates to a generation cost of around $500-550/MWh. With the APC now set at $600/MWh until 30 June 2028, the AEC considers that the financial incentives are now better aligned in such a way to ensure that generators will continue to make generation available in the market during an administered pricing period (APP).

Level 14, 50 Market Street
Melbourne 3000
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E info@energycouncil.com.au
W energycouncil.com.au

ABN 92 608 495 307

Generators already have a strong incentive to offer availability into the market. If market bodies are concerned about a lack of availability, a better approach is to understand why this is the case, rather than simply assuming profiteering on the part of generators. The solution to a lack of availability is not to impose an availability obligation, but rather to ensure the correct incentives are in place for generators to make themselves available in times of market stress.

On this basis, we are concerned that the options identified by the AER focus more on imposing mandatory obligations without an understanding of the key issues arising from the market suspension. These options include:

- removing commercial considerations from the list of reasonable causes for causing a direction in clause 4.8.9(c2)
- introducing a positive obligation on generators to continue to offer capacity into the market during actual Lack of Reserve (LOR) 2 or LOR3 conditions during an administered price period (APP), and
- introducing an obligation for generators to use the available price bands during APPs.

The NER does not include a reference to a 'list of reasonable causes for causing a direction'. Irrespective, we do not support this element of the AER's proposal nor the implication that generators withheld supply during times of market stress for purely commercial reasons. Reform should focus on addressing the underlying incentives within the compensation regime, as ideally, it would be preferable for AEMO to rarely be required to direct.

We do not support a positive obligation to offer capacity into the market as outlined by the AER. The NEM is an energy only market, not a capacity market and implementing a capacity obligation would undermine the effective operation of the NEM. This is particularly the case when significant portions of energy are contracted ahead of time, meaning making capacity available undermines these incentives to forward contract.

Likewise, the AEC does not support the proposal to introduce an obligation for generators to use the available price bands during APPs. In our view, this recommendation would do little to improve AEMO's ability to dispatch generation during an APP while imposing an unnecessary obligation on generators for no benefit to the market.

Question 4: Methodology

1. *Do stakeholders have any suggestions related to the directions compensation framework that could enable it to more effectively meet its objective to fairly compensate directed participants without creating a perverse incentive to be directed?*

The AEC believes that there should be maximum consistency across different compensation frameworks. This would help make generators ambivalent about whichever compensation framework is used. Given the objective of each framework is to maintain incentives for generators to remain in the market at times of market stress, we are of the view that there is no reason for different frameworks to have different compensation frameworks.

A simplified arrangement with a single compensation approach for constrained on directions, administered pricing and market suspension compensation would work improve the framework and reduce the potential for distortions to arise. This should include compensating for the same costs across all three frameworks using identical calculations. We also consider a single market body, such as AEMO, should handle all claims. In our view there is little reason to have different compensation frameworks managed by different market bodies.

2. *Do stakeholders consider there is value in having different approaches to the various compensation frameworks? Would better outcomes be more likely if the frameworks were consistent where possible?*

Same as 1.

3. *Should opportunity costs be considered in the compensation frameworks? If so, which ones and why?*

Opportunity costs exist regardless of which approach is used to bring generation into the market, whether it's by constraining on, direction, market suspension or administered pricing compensation. For all energy limited scheduled generators, a MWh that is dispatched at one time cannot then be dispatched again at a later point in time. That means that by being forced to dispatch at a time when they otherwise may not otherwise choose to be available in the market, they are forgoing the potential revenue at a different point in time.

Opportunity costs must also have regard to the underlying economics of different types of generation. For example, for battery energy storage systems (BESS), the value of having BESS in the energy market is maximised when they are free to charge at times of low prices and dispatch at times of high prices. Interfering in this cycle through directions or any other framework which doesn't capture opportunity costs would damage the incentives for batteries to remain in the market at critical times.

For hydro, compensating based on SRMC is not a meaningful approach, as the fuel is essentially free, with the value of the water linked to market opportunities. That means opportunity cost is the only meaningful way to compensate for hydro generation. Opportunity cost is linked to marginal pricing, as in the NEM all generators, regardless of their cost of generation, receive the marginal price.

There should be opportunity cost consideration for forms of thermal generation with regards to their fuel stockpile. Having been dispatched at a time not of their choosing, a thermal generator may experience increased costs for sourcing replacement fuel that exceeds that which they might have already contracted.

The AEC, therefore, strongly supports the consideration of opportunity costs within the compensation frameworks. A more consistent approach across all three of the compensation frameworks, as previously noted, should likewise be supplemented with a consistent set of standardised direct costs, covering all potential direct costs, alongside a codified procedure for opportunity costs to be used. Codification of direct costs offers the prospect that these costs can be calculated expeditiously, with compensation paid in a timely manner. This is to the benefit of both the relevant market participants and their customers. Currently, larger customers are bearing uncertainty on costs as compensation claim payments are delayed, so any mechanism to streamline the simpler direct cost compensation is beneficial.

4. *Do stakeholders agree with providing more codification and guidance about how opportunity cost compensation is likely to be assessed?*

Upfront certainty is key, so that generators know ahead of time the nature of compensation they will receive, resulting in the incentive to continue to generate when the market is under stress.

5. *Do stakeholders consider that changes to the compensation frameworks may be necessary due to the advent of battery energy storage systems? If so, are there any specific changes that should be considered?*

As in the answer to 4. calculation of opportunity costs might need to be technology specific. Batteries, which intend to charge in periods of low price, and dispatch in periods of high price would face unique financial risks if a direction disrupted this cycle.

6. *Do stakeholders consider that administered pricing compensation provides a sufficient incentive for participation in the market during an APP? If not, please explain why and include any measures that could be considered as part of this review.*

We do not believe the APC in place for the events of June 2022 provided sufficient incentive for participation in the market, noting that subsequent changes may have resolved this issue.

7. *Do stakeholders agree with the suggestions made by the AER regarding removing economic considerations for causing a direction given the availability of compensation?*

The AEC does not support the suggestions made by the AER regarding removing economic considerations for causing a direction. Commercial consideration should very much be considered reasonable under these circumstances. The AEC believes that amending clause 3.9.7(b) to allow for compensation when generators are constrained on, would largely negate the need for generators to bid as unavailable in order to ensure they don't run at a loss. This would render the proposed amendments to clause 4.8.9(c2) unnecessary.

8. *Do stakeholders have a preference for a benchmark approach to compensation such as the market suspension compensation framework, or a more open framework such as the administered pricing compensation framework?*

We support a consistent approach across the three compensation frameworks forming part of this review. We recommend that a consistent set of direct costs, which covers all potential direct costs, along with a codified procedure for opportunity costs be used to compensate all generators. It would be reasonable for opportunity costs to be considered over different timescales for different fuels to recognise their operating cycles. When considering direct costs, these must be determined and set such that the potential for additional costs claims is minimised. We consider the current benchmark provisions in this area are grossly deficient leading to unnecessary and time-consuming claims for additional compensation.

Chapter 5

Question 5: Governance

1. *Do stakeholders think it is appropriate to have a single point of receipt for all compensation claims to reduce confusion?*
2. *Who should be responsible for the various compensation frameworks?*
3. *Are there any other governance issues that should be considered?*

From a governance perspective, the AEC agrees that a single point of receipt could go towards the aim of greater simplicity and clarity. We support AEMO being responsible for all compensation frameworks in the NEM. Given AEMO's experience in administrating direct cost claims and the Operators ability to access relevant data to determine direct cost claims, we agree with the Commission that this option would reduce the administrative burden for competing claims.

Irrespective of the eventual option chosen, the AEC believes that it is paramount to resolve the underlying uncertainty around the timeliness of compensation assessments and payments. At present, the AEMC has

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E info@energycouncil.com.au
W energycouncil.com.au

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not been able to process the claims promptly. Moreover, we believe that granting the AER responsibility for this process would only risk further delays, given the need to establish a dedicated resource to process claims which would take time to implement.

Chapter 6

Question 6: Overlapping Compensation Claims

1. *Do stakeholders agree with the issues identified regarding overlapping compensation claims?*
2. *Do stakeholders agree with the potential solutions identified to address issues arising from overlapping compensation claims? Do stakeholders prefer a particular option or propose other options for consideration?*

Should a consistent approach to compensation be implemented, as indicated previously, the issue of overlapping compensation claims should largely be removed.

Question 7: Timeframes for supporting Information

1. *Is it appropriate to include timeframes for administered pricing compensation claims?*
2. *Should additional time be provided for opportunity cost claims, and if so, how much?*

The AEC appreciates the need for defined timeframes for market participants to submit supporting information for opportunity claims. We suggest that a period of 40 days would suffice.

The level of supporting information, however, should be well defined, and not too onerous so that market participants have ample opportunity to meet the timeframes.

Importantly, the relevant market body should also have defined timeframes for assessment of any compensation claims. Remuneration to generators needs to occur in a timely matter to ameliorate the uncertainty that has resulted from the compensation claims process. Indeed, claims for market suspension and directions were only finalized by AEMO in February 2023, over 6 months after the crisis. To date, the Commission is still assessing the opportunity cost methodology.

Question 8: Harmonising Definitions

1. *Do stakeholders agree that there would be benefits in aligning definitions of cost categories across the various compensation frameworks?*

The AEC agrees that there would be benefits to aligning the definitions of cost categories across compensation frameworks.

Question 9: Cost Recovery

1. *Do stakeholders consider that cost recovery provisions for administered pricing could be clarified with respect to situations where there are multiple "home regions"?*
2. *Do stakeholders have any thoughts on the existing cost allocation mechanisms for the compensation frameworks?*

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Cost allocation should ideally be done along a beneficiary pays basis, noting that this can be challenging to discern at times.

Question 10: Information to support a claim

1. *Do stakeholders have suggestions for NER requirements and/or guidelines changes that could provide greater clarity for administered pricing compensation claimants?*
2. *Do stakeholders have views on the level of evidence that is required to substantiate claims under the current compensation frameworks?*

The AEC would support further guidance from the AEMC on the standard of information required to support a claim to provide clarity to market participants and to reduce the time taken to process further claims.

On the level of evidence, there needs to be a balance between the need for evidence to be substantiated with sufficient rigour to demonstrate that the costs are genuine with need for the process to remain simple and clear as not to create difficulties when participants supply information or prevent claims that are made on the basis of genuine costs.

Questions about this submission should be addressed to David Feeney by email at david.feeney@energycouncil.com.au.

Yours sincerely,

David Feeney
General Manager, Wholesale and Environment