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Review into electricity compensation frameworks

Alinta Energy welcomes the AEMC's self-initiated review into compensation frameworks in the NEM. It is important that these frameworks are considered as a whole, rather than being subject to piecemeal review which is likely to create design conflicts and contribute to existing sources of market failure.

The key points of Alinta Energy's position are summarised as follows:

1. The objectives of the compensation frameworks should be to ensure timeliness and accuracy of compensation.
2. Compensation should be comprehensive and not exclude costs (assuming that they can be proved) because they fall into or outside of an arbitrary categorization such as 'opportunity' or 'direct' costs.
3. Compensation frameworks should be aligned to the extent possible to avoid perverse incentives and reduce complexity for participants.
4. Further to (3) above, the AEMC should extend compensation frameworks to cover cases of constrained-on dispatch to avoid reliance on directions. Constrained-on units should be eligible for compensation on the same basis as directions where they are dispatched below their relevant offer. This feature of the current market is a primary cause of directions in the NEM.
5. The current model for directions compensation (at a high level) is good design, familiar to market participants, and is a strong candidate as a model for compensation in the NEM generally. The model is a two-stage process that simultaneously allows for a fast-tracked payment based on a benchmark (currently 90^{th} percentile price but may be some other metric) while providing additional compensation where it can be proved that losses (howsoever categorised) have been incurred in excess of the benchmark.
6. We support the AEMC in further reviewing the formulation of the benchmark for compensation for directions (and the other frameworks if the AEMC decides to extend the design of the directions compensation provisions further) but consider that a benchmark based on short-run marginal cost with a 15% premium would be inadequate.
7. Further codification/guidance as to the expected standard of proof for compensation claims would assist in achieving the objectives of the compensation frameworks by increasing transparency and confidence in the process for participants.

We note the context of this review against the backdrop of the events of winter 2022. As stated above, the directions compensation process is well understood by participants and has several advantages over both administered pricing and the market suspension framework. It is our view that the following factors may have contributed to participants preferring directions compensation over the other frameworks:

1. A lack of experience and transparency with the administered pricing and market suspension compensation processes and how the AEMC would assess costs increased the risk associated with the compensation.
2. Market suspension compensation is more limited in scope.
3. Administered pricing compensation does not provide a default payment based on a benchmark that can be determined and settled quickly.

Our responses to the questions posed in the draft determination follow.

Assessment framework and objectives
The primary objective behind compensation frameworks should be to place the participant providing the service to the market in the position as if the market failure (market suspension, administered pricing and directions being examples of market failure) had not occurred. As identified in the consultation paper, over-compensation is problematic because it creates an incentive for a participant to seek market failure rather than participate in the market. On the other hand, under-compensation punishes and disincentivizes participants who are providing critical services during such times for the benefit of participants who are not.

A secondary, but often competing objective, that should be considered a key criterion is the timeliness of compensation. Significant delays to the determination and payment of compensation (due to impacts on cashflow, risk and customers) are as likely to lead to negative outcomes for the market as over or under-compensation, and place additional burdens on customers.

Achieving the objectives
Setting aside the issue of whether a 90th percentile price is set at an efficient level as a proxy for energy compensation, Alinta Energy considers that the high-level design of the current directions' compensation process strikes a good balance between competing needs for complete compensation and timely resolution of compensation claims. The design of the compensation provisions for directions provide a 'fast-tracked' payment based on a benchmark price (currently the 90th percentile price) as well as providing confidence to market participants that if material losses exceeded the compensation under NER 3.15.7 that the participant would be kept whole (eventually) pursuant to NER 3.15.7B.

In addition to the above, we note that while we did not support the formulation previously proposed by the Commission around the benchmark-based compensation, (being SRMC plus a 15% premium, which we consider inadequate – for example an SRMC based on the ISP would not cover likely start-up costs which can be very substantial) we do not object to the concept of bespoke benchmarks for generation types generally and support the AEMC continuing to progress work on the design, providing that the possibility of compensation based on actual losses where the benchmark falls materially short (such as in NER 3.15.7B) is retained.

Methodology – alignment of compensation frameworks
Alinta Energy does not consider that the objectives for directions compensation are fundamentally different to that for periods of market suspension or administered pricing. In the short run, under-compensation for directions will contribute to threats to power system security (as participants seek to avoid being subject to a direction rather than focusing on supporting the market operator) and in the long run will lead to undersupply of critical services that can be the subject of a direction. It is also important that participants can communicate openly with the market operator about their capabilities during emergencies without fear of financial punishment due to inadequate compensation. Accordingly, it is our view that the objectives described in the response to questions above apply equally to each of the frameworks that are the subject of this review.

On the basis that the objectives of each compensation framework are aligned, as a general principal, the methodology of each compensation framework should also be aligned to the extent possible to ensure that one form of compensation is not preferred to another.

Methodology – opportunity costs and cost categories generally
From the perspective of participants, the distinction between different types of costs - direct, consequential, opportunity etc. - is largely arbitrary. They are all real costs that will impact the business financially due to providing the service which is the subject of the compensation. For this reason, compensation should not exclude opportunity costs.

Methodology – removal of economic considerations from reasonable causes for causing a direction
Alinta Energy does not support the AER's proposal to remove economic considerations from reasonable causes for causing a direction as per NER 4.9.8(c2) on the basis that the AER's premise (that there is not a strong rationale to fear making a loss) is incorrect, because:

1. Under compensation frameworks that place a burden of proof on participants, there is considerable uncertainty around whether a participant will be able to meet the requisite standard of proof in respect of each cost incurred.
2. NEM compensation is not always applicable. For example, a unit that is constrained on in dispatch will be paid at the pool price regardless of their bids. Where the pool price is below cost, the unit has no option but to bid unavailable to avoid being dispatched at a loss.

If improvements are made to ensure that compensation is reliable and comprehensive (covering all categories of cost incurred in all relevant circumstances, including constrained-on dispatch), then Alinta Energy would support such a provision. I

Governance:
Alinta Energy considers that AEMO is an appropriate body to receive and administer compensation claims. AEMO will inevitably be involved in compensation determinations regardless and the lower administrative burden and simplicity associated with AEMO being responsible for all compensation frameworks in the NEM should allow for more consistency and cost-effective compensation assessments.

Overlapping compensation claims:
Alinta Energy supports option 1, due to its simplicity and the fact that it removes perverse incentives associated with the consideration of trading intervals that are not impacted by the administered price cap.

Timeframes for supporting information
As noted above, significant delays in the resolution of compensation claims (for whatever reason) are problematic from a cashflow and forecasting perspective for participants and customers. We support the AEMC introducing timeframes for supporting information for compensation claims. We do not have a view on how much additional time should be allowed for claims including opportunity costs.

Harmonising definitions
Alinta Energy supports the alignment of the NEM compensation frameworks to the extent possible and by extension, the alignment of cost categorization to ensure consistency and avoid perverse incentives during periods with overlapping claims.

Information to support a claim
Alinta Energy supports further codification/guidance as to the expected standard of proof for compensation claims and we note that it may be difficult to be prescriptive around compensation claims that include opportunity costs. We suggest that the AEMC explicitly adopt the standard of proof applicable in civil law, being 'on the balance of probabilities'.

If you would like to discuss this, please contact me at hugh.ridgway@alintaenergy.com.au.

Yours sincerely,

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