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Australian Energy Market Commission
Level 15, 60 Castlereagh Street
Sydney NSW 2000

Submitted electronically

Review into electricity compensation frameworks - Draft Report

Snowy Hydro Limited welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Draft Report for its Review into electricity compensation frameworks (Draft Report).

Snowy Hydro commends the AEMC for the Draft Report. The structural changes inherent in the energy transition underscore the need for an appropriate compensation framework. Snowy Hydro considers that the existing framework has not kept pace with these changes and, in particular, we are pleased that the Draft Report acknowledges the fundamental importance of opportunity cost as an appropriate compensation metric.

We set out our comments in response to the recommendations below.

Draft recommendation 1: Each compensation framework should have an objective, and the objective for directions compensation should be to enable generators to be compensated for the costs associated with complying with a direction. The administered pricing and market suspension frameworks will remain the same.

Snowy Hydro supports the adoption of a single objective for the compensation framework. Although a direction represents a different type of intervention than administered pricing and market suspension, the objective should be the same - generators should be appropriately compensated, and that this is achieved by determining a level of compensation that maintains an incentive to supply. A level of compensation which does not maintain this incentive is likely to undercompensate generators and create distortions.

Snowy Hydro does not agree that such an approach would incentivise participants to seek directions; that is an issue relating to the compensation methodology, not its objective. Attempting to differentiate between compensation which, on the one hand, compensates generators for the costs associated with complying with a direction and, on the other, which maintains the incentive to supply, is to draw a false distinction; the level of compensation which appropriately compensates generators for their costs (fully considered) will also incentivise supply. Furthermore, Snowy Hydro does not agree that directions should be distinguished from administered pricing and market suspension on the basis that the latter (only) represent periods of market stress. Directions are also strongly indicative of system stress, hence their usage as a last resort mechanism.

Draft recommendation 2: Participants should be eligible to claim opportunity costs in each of the directions, administered pricing and market suspension compensation frameworks.

Snowy Hydro supports participants being able to claim opportunity cost in each of the directions, administered pricing and market suspension compensation frameworks. It is an important principle, both for reasons of fairness and the efficient operation of the market; generation should be adequately compensated in response to all types of market intervention. The current approach to directions compensation, based on the 90th percentile prices over the preceding 12 months, does not reflect the cost of operating a fuel constrained plant. For storage assets, the marginal cost is linked to the shadow value of energy, that is, the cost of incremental supply (or the source of marginal generation). In effect, the marginal cost of storage *is* opportunity cost. It is therefore important that directed generators should be entitled to claim opportunity cost compensation.

Failure to compensate fuel constrained plant for opportunity cost for directions or during market suspension will very likely undercompensate asset owners, distorting investment signals and the efficient allocation of resources. As acknowledged by the AEMC, it is particularly important that the compensation framework supports revenue adequacy for storage assets given their growing importance for system reliability.

Draft recommendation 3: The upfront payment for directions compensation should be changed to reflect the volume-weighted average price received by assets of the same technology type in the same region for the previous 12 months.

Snowy Hydro considers that the current approach to upfront directions compensation, using a 90th percentile volume-weighted average price across all trading intervals during a year, remains a reasonable approach, and we have some reservations about attempting to infer generator costs by reference to the pricing outcomes of a sub-portion of trading intervals (ie. linked to a specific technology). As the AEMC is aware, the NEM is a marginal market where the price received by all generators is set by the market-clearing source of generation.

Nevertheless, we agree that the VWAP received by a particular asset type over a 12 month period should tend to reflect its cost/earnings structure, and that this may therefore be a reasonable approach to calculating upfront directions compensation. However, to the extent it is adopted, such an approach should be complemented by the ability to recover directions compensation (as proposed by the AEMC) and, as already permitted under the Rules, any additional direct costs. The ability to recover additional direct costs is an important safeguard for periods of high fuel prices (for example, during the 2022 energy crisis), which may not be reflected in the 12-month VWAP.

Draft recommendation 4: The upfront payment for market suspension compensation should be the greater of the MSPS price and the upfront payment for directions (calculated as The VWAP).

Snowy Hydro agrees that the upfront payment for market suspension compensation should be the greater of the MSPS price and the upfront payment for directions. The current benchmark value for hydro assets in the market suspension pricing framework is

$9.87/MWh; self-evidently, this does not represent adequate compensation. Furthermore, compensating certain types of generators, such as an open cycle gas turbine asset, based on pre-estimates of SRMC may be inadequate when those assets have been required to start-up at short notice, given fuel costs may, at that time, be at a premium.

More generally, Compensation based on the estimated short-run marginal costs of particular generators will not not improve the framework's cost efficiency for the same reason that the NEM is not settled based on individual short-run marginal cost.

Using a 12-month VWAP, either based on the current 90th percentile approach or based on the VWAP achieved by a particular asset type, would represent a fairer approach to compensating generators during market suspension. It would also help ensure generator availability, and therefore the reliability of supply when the market has been suspended.

Draft recommendation 5: All compensation claims should be lodged with AEMO.

Draft recommendation 6: AEMO, using the independent expert function, should assess claims for administered pricing in addition to the directions and market suspension compensation frameworks. All claims for opportunity costs should be assessed by the independent expert.

The AEMC, AEMO and other bodies did a significant amount of work during the 2022 crisis. Snowy acknowledges it was an unprecedented time in the operation of the NEM. However, conflicting and uncertain interpretations of the compensation frameworks ultimately reduced confidence in the compensation process. Snowy Hydro therefore supports the recommendation that all compensation claims should be lodged with AEMO and that an independent expert should be used to assess opportunity costs.

As mentioned, the current approach, whereby some compensation claims are lodged with AEMC and others with AEMO, adds unnecessary complexity and confusion. Snowy Hydro agrees that a single point of receipt for all claims will maximise certainty and confidence in the compensation process. AEMO already has significant experience managing and assessing compensation claims (including those arising from the 2022 crisis). It is appropriate that all claims should be lodged with AEMO, and that an independent expert be retained for opportunity cost claims, given their additional complexity.

Draft recommendation 7: The Commission should retain responsibility for the guidelines for assessing opportunity cost claims. These guidelines will apply across all frameworks.

Snowy Hydro agrees that the AEMC should retain responsibility for the guidelines for assessing opportunity cost claims and that these guidelines should apply across all frameworks. However, Snowy Hydro considers that the current guidelines should be clarified in relation to their preferred methodology for calculating opportunity cost. In particular, the valuation hierarchy in clause 5.3.4 of the guidelines prefers a "*market based valuation of an alternative that over the relevant period of time would justify an opportunity cost*": this should be amended to explicitly bring in-scope the existence of a generator's forward contract positions, and the fuel costs incurred by a generator to defend those positions.

The bounds of a fuel-constrained generator's opportunity cost is, to a large extent, determined by its contracted position, because those contracts represent pre-sales of energy that must be defended from a fixed fuel resource. If that same fuel resource, which was reserved by a generator ahead of time to defend its contract positions, is depleted at a time not of its choosing (due to a price limit event) it must find other ways in which to manage its exposure. The cost of managing its exposure to contract positions, including in particular its fuel costs, will usually be a fundamental determinant of opportunity cost.

To not acknowledge the existence of a generator's contracting arrangement, as occurred in the AEMC's assessment of Snowy Hydro's opportunity compensation claim for the administered pricing period during the 2022 energy crisis, will not permit a proper assessment of the alternative opportunities that were available for the resource in question. Attempting to assess opportunity cost by reference to historic VWAP may be administratively attractive, but it cannot substitute for a genuine assessment of the alternative future uses for the resource in question. Snowy Hydro considers that this issue should be addressed as a matter of priority.

Draft recommendation 8: Administered pricing compensation should be assessed by trading interval within an eligibility period rather than by net revenue in an eligibility period.

Draft recommendation 9: Administered pricing compensation should be assessed on an individual unit level rather than across all units that make up a claim for compensation.

Snowy Hydro supports these recommendations. The current compensation methodology, in which eligibility is determined by effectively netting off revenue between different generating units over the course of a day, does not facilitate an accurate calculation of opportunity cost compensation. For a fuel-constrained generator, the critical factor in determining if an opportunity cost arises in relation to a given quantity of fuel is whether or not there was a better alternative use for the fuel in question. Revenue earned by the generator from other resources on the same day is irrelevant to, and should not be a consideration in determining, the opportunity cost for the resource in question - yet that is not the case under the current arrangements. Snowy Hydro considers that this reform is critical to maintaining the incentive for generators to supply during APC events, as it will enable a more accurate calculation of generator opportunity costs.

Draft recommendation 10: There should be the same time limits on all compensation claims including claims for administered pricing compensation. The time limits should be aligned with AEMO's intervention settlement timetable, which currently sets out the timeframes for directions and market suspension compensation processes.

Snowy Hydro supports extending the time available to participants to notify AEMO of a claim for compensation to 15 days, rather than the current requirement of 5 days.

However, the draft recommendation to require supporting information be provided within 33 days is too short, particularly for claims involving opportunity cost. APC events can be disruptive and that it can be challenging for participants to immediately assess their impact. Organisational resources may also be stretched during the period when an APC event occurs and this can pose challenges in gathering the required information. Snowy Hydro considers that a period of at least 45 days for the provision of supporting information would be more appropriate.

Draft recommendation 11: The same types of direct costs should apply to all compensation frameworks and be identified in a single list.

Snowy Hydro agrees that there is merit in standardising the types of direct costs that should apply to all types of compensation frameworks. However, we do not consider that such a list should be exhaustive. It is possible, and perhaps likely, that new types of direct costs will arise in future. The compensation framework should be flexible enough to accommodate new classes or types of costs without needing to amend the Rules to allow their consideration.

Draft recommendation 13: Costs of capacity directions should be recovered from consumers only. Do stakeholders agree with this approach to cost recovery?

Snowy Hydro supports this recommendation. Ultimately, directions are issued to support reliability of supply, and the supply of energy is paid for by consumers. The current approach to allocating the cost of capacity directions (between generators and consumers) is inconsistent with the approach for other types of directions. Snowy Hydro agrees that this creates potential distortions and does not represent an efficient allocation of costs.

Draft recommendation 14: The same standards of supporting information should be required across all compensation frameworks.

Snowy Hydro agrees that in principle, it is reasonable that the same standards of supporting information should be required across all compensation frameworks. However, care should be taken that such standards do not directly or indirectly restrict the types of supporting information able to be provided. This is particularly important for opportunity cost claims, which usually require a 'what-if' analysis and which will depend on the circumstances of the particular claimant and the alternative opportunities which arose. The current standard of information required in the Rules, such as fuel fuel supply contracts or proof of transactions, may be unduly restrictive when attempting to demonstrate an alternative opportunity. Accordingly, if the AEMC adopts similar standards across compensation frameworks, allowance should be made for the fact that opportunity cost claims are inherently less certain and may require more flexibility in respect of supporting information.

Furthermore, Snowy Hydro does not agree that the Rules should stipulate a level of seniority for sign-off on claims. It is unclear what the purpose of such a requirement would be or that it would produce any real benefit. In any case, the AEMC ought to be able to rely on the ostensible authority of those submitting the claims, or other information, on behalf of the claimant.

About Snowy Hydro

Snowy Hydro Limited is a producer, supplier, trader and retailer of energy in the National Electricity Market ('NEM') and a leading provider of risk management financial hedge contracts. We are an integrated energy company with more than 5,500 megawatts (MW) of generating capacity. We are one of Australia's largest renewable generators, the third largest generator by capacity and the fourth largest retailer in the NEM through our award-winning retail energy companies - Red Energy and Lumo Energy.

Snowy Hydro appreciates the opportunity to respond to the Draft Report.