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26 September 2024

Ms Anna Collyer
Level 15
60 Castlereagh Street
Sydney NSW 2000

Submission: EPR0095

Dear Ms Collyer,

Submission: Review into electricity compensation frameworks

This letter and attached constitutes AEMO's submission to the Draft Report on the Review of electricity compensation frameworks.

AEMO supports the AEMC's intention and recommendations to strengthen, align and streamline the electricity compensation frameworks. Simplifying the compensation frameworks for directions, administered pricing and market suspension provides confidence to market participants and supports the stable operation of NEM during periods of market disruption. This in turn will support the reliable and low-cost supply of electricity to consumers over the course of the energy transition.

AEMO appreciates this opportunity to respond to the Draft Report and supports most of the draft recommendations. Overall AEMO considers the recommendations to streamline the governance and administration of the framework will have a significant impact in providing market participants with confidence they will be adequately compensated for services, while increasing the effectiveness of the application of the frameworks to appropriately apply in a range of scenarios over the course of the energy transition.

For AEMO the recommendations include additional responsibility over administered pricing compensation, processing of opportunity costs and any implementation of change to an upfront compensation methodology. Our comments, in the attached submission, focus on specific aspects of the AEMC's recommendations, including discussing the risks associated with the recommended upfront compensation methodology.

Please do not hesitate to contact david.scott@aemo.com.au if you would like to discuss any of the matters raised in this submission.

Yours sincerely,

Violette Mouchaileh
Executive General Manager - Reform Delivery

Attachment A: Detailed comments on the AEMC compensation frameworks review draft report

AEMO considers this review is an important opportunity to recommend an enduring compensation framework that provides clarity to market participants and operates with administrative efficiency.

Our overall comments on the draft report are as follows.

Combining the frameworks

AEMO supports the AEMC's many recommendations that make the frameworks more consistent. AEMO is of the view that the compensation frameworks for directions, market suspension and administered pricing under the National Electricity Rules (NER) should be designed as much as possible to operate as a single clear, simplified and streamlined framework and process. This will provide market participants with confidence that they will be adequately compensated for services, whilst reducing industry and consumer costs. Simplifying the frameworks will also support the application of the frameworks across a range of scenarios that may occur over the course of the energy transition.

While these amendments should streamline and reduce overall costs of the framework, it is likely that the proposed changes will increase AEMO's costs, primarily due to taking on administered pricing compensation and the processing of opportunity costs[1] from the AEMC. An option for recovery of these costs could include a flat $5,000 fee for additional claims across the frameworks. A fee for recovery of additional claims is currently applied in the Rules for only market suspension compensation NER3.14.5B(e) to assist with the recovering the costs associating with processing the claims[2]. This could be extended to directions and administered pricing compensation where appropriate.[3]

Efficiency of compensation frameworks

It is important to note that the cost and impacts of compensation frameworks are not limited to the amount paid to generators for compensation. A clear driver of inefficiency in compensation frameworks is the administrative burden to market participants and AEMO of preparing, processing, and assessing claims. The claims processes can create inconsistencies across the frameworks and its outcomes may be uncertain for market participants. AEMO's submission, in part, focuses on how to reduce the administrative burden of claims and minimise the overall cost and impact of the compensation frameworks. For example, AEMO is of the view that the upfront payment methodology should minimise unnecessary claims in addition to maintaining necessary cashflows. This means that the upfront compensation approach should be set at a sufficient level to cover all a generator's costs under typical circumstances.

Other compensable services

Although not explicitly discussed in the draft report, AEMO considers this review is an opportunity to consider how the 'other compensable services' framework functions. Other compensable services (NER 3.15.7A) are currently used for payment to directed participants for services other than energy and market ancillary services. This is used as a catch-all for all other AEMO directions with participants eligible to receive 'fair payment compensation (NER 3.15.7A(f)). AEMO considers that this framework would benefit from being clarified and where possible, amalgamated into the other electricity compensation frameworks.

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[1] Assessed by an independent expert

[2] https://aemo.com.au/-/media/files/stakeholder_consultation/consultations/nem-consultations/2020/wholesale-demand-response/final-stage/market-suspension-compensation-methodology.pdf?la=en&hash=4D9C7546C80F984B0808862E48871CD0

[3] It may not be appropriate to include a fee for additional claims for directions direct costs

AEMO considers that the current drafting of NER 3.15.7A could be improved to provide sufficient clarity to industry that they will be compensated, as appropriate, for all directions received from AEMO. This is of particular importance, as the services required, and how such services are provided will continue to evolve with the energy transition where AEMO is likely to be required to issue new and different types of directions. One such example - AEMO is currently considering how to manage system operations during periods of minimum system load, and this may include directions to batteries to discharge and then retain a low state of charge to then be available to charge during periods of minimum system load.

To support the energy transition, it is important to ensure that under all circumstances directed participants are provided with confidence they will receive compensation for directions. To this end, AEMO considers the following warrants further consideration:

- Broadening and clarifying the other compensable services framework so it clearly applies in a broad range of future scenarios, and
- Extending the AEMC's opportunity cost guidelines to other compensable services.

AEMO's specific comments on each of the draft report's recommendations are set out in the following sections.

Objectives (recommendation 1)

AEMO agrees that each compensation framework should have an objective defined in the NER and supports the introduction of an objective for the directions compensation framework.

Having said that, where the AEMC seeks to align governance and administration of the frameworks, they may also consider alignment of objectives if appropriate. This could support consistent application and drafting of the Rules. If this was to be the case, the objective may need to be drafted at a higher level to apply across all frameworks, for example 'to provide sufficient compensation to ensure the continued provision of services necessary to maintain the operation of the NEM in line with the interests of consumers'.[4]

Methodology (recommendations 2, 3, 4)

AEMO broadly supports the AEMC's recommendations to align the compensation for directions and market suspension compensation (where this is appropriate) and to clarify the claims process for opportunity costs under each of the compensation frameworks. However, AEMO retains some concerns regarding the potential and administrative burden to both industry and AEMO of these Rule amendments that are ultimately borne by consumers. Specifically, where changes to the upfront compensation methodology risks continuing the use of a large volume of additional claims.

Below AEMO comments on the AEMC's recommendation to change the upfront compensation methodology to the volume-weighted average price by the technology type in the relevant region over the previous 12 months ('VWAP') (recommendations 3 and 4).

[4] This objective is sufficient to scenarios where an incentive is required (market suspension and administered pricing) or when a direction is received as it would not be in the interests of consumers to incentivise participants to seek directions – and hence this does not align with the objective.

Upfront compensation methodology

The upfront compensation methodology should endeavour to pay enough to avoid inefficient additional claims and their associated costs and risks to market participants and AEMO. This is in addition to its role in supporting generator cash flow as set out in the draft report.[5]

There is no perfect upfront compensation methodology to calculate the level of costs incurred by each participant. AEMO has considered options regarding the upfront compensation process and has not identified a preferred one. Past prices are not necessarily reflective of current and future costs. Targeted benchmarks are more difficult and time consuming to apply. Aggregate benchmarks are less accurate and hence more likely to strike the wrong balance in either paying too much or too little in upfront compensation.

Over the course of the energy transition thus far, the general trend has been an increase in the use of the compensation frameworks. We note the AEMC's view is that the increase to the administered price cap is likely to lead to fewer claims for compensation in the future and that the Improving Security Frameworks for the Energy Transition rule change also aim to reduce the reliance on directions for the management of system security issues.[6] While AEMO agrees and supports the introduction of these measures, AEMO considers that the compensation frameworks, and the confidence they provide the sector, remain important.

The claims process introduces costs and risks that may otherwise be avoided with appropriate upfront compensation. Regardless of the specific methodology, upfront compensation should ideally be set at a level high enough to maintain the efficient operation of the market. If the upfront compensation methodology is set too low too much reliance is placed on the claims process to ensure market participants are appropriately compensated, leading to:

- industry and AEMO needing to dedicate resources to preparing and processing claims at the expense of more value adding endeavours.
- during significant events, increased stress on the resources dedicated to preparing and assessing claims.
- in some instances, costs of preparing and processing claims being higher than the compensation paid (after including AEMO and the Independent Expert costs to that of the applicant).

Given the risks, market participants may be disincentivised to provide services where they lack confidence regarding the outcomes of the claims process.

It is in this context, that AEMO is cautious in the use of the proposed VWAP by technology type due to the VWAP leading to a higher than optimal volume of claims, as:

- half the time the VWAP upfront compensation will be less than what any given generator has recovered in the past (assuming evenly distributed generator costs),
- Supply constraints and higher input costs are likely to be a driver of future market interventions. In such circumstances previous average prices are unlikely to reflect current marginal costs,

[5] AEMC, 2024, Draft Report – Review into electricity compensation frameworks, p15 - https://www.aemc.gov.au/sites/default/files/2024-08/EPR0095%20-%20Review%20into%20electricity%20compensation%20frameworks%20-%20Draft%20report.pdf

[6] AEMC, 2024, Draft Report – Review into electricity compensation frameworks, p2 - https://www.aemc.gov.au/sites/default/files/2024-08/EPR0095%20-%20Review%20into%20electricity%20compensation%20frameworks%20-%20Draft%20report.pdf

- the VWAP does not account for the costs of generation (i.e. start-up costs, heat rate performance) that may no longer be under the control of the participant and affect the average price a generator would need to receive to recover its costs,
- Varied costs between generating units within the same technology type,
- VWAP uses generator output when operating in the market. Where a unit is directed, it would typically operate at lower levels than when bid into the market – the minimum generation required (min-gen) to adhere to the direction. The VWAP per unit cost calculated is therefore lower than the per unit cost when operating at min-gen. This will then typically undercompensate generators on a per unit level resulting in claims for most directions.

Further considerations that would need to be worked through prior to implementation include where a generation technology type has not generated in the past 12 months, dual fuel generators and where there is a single generator being the only price setter in a certain category.

In addition to any recommendation on the upfront compensation methodology, AEMO considers the following warrants further consideration to streamline compensation more broadly and minimise the costs and impacts of the compensation frameworks:

- A **threshold for all compensation claims** to ensure that the costs of processing claims are not greater than the additional compensation (this could be an extension of the current threshold of $5,000 per claim that is currently applied for directions under Clause 3.15.7B (a4) of the NER to market suspension and administered pricing).
- A **higher level of initial compensation to**
  - Reduce the need for additional claims and bolstering the incentive to maintain the provision of services.
  - Offset the risk that a threshold for compensation claims may disincentivise participants from providing services during periods of market suspension.

  Such an approach would align with the intent of the current 15% premium currently applied to benchmark compensation for market suspension. This would provide an incentive for more generators to provide services under market suspension despite variability in costs between generators within the same technology class.
- A **fixed cost factor** – an allowance applied when the preliminary compensation approach may not otherwise account for the fixed costs of generation.
- A **cap** on the total amount paid in preliminary compensation being, on a per unit basis, no more than the Administered Price Cap.

In summary, AEMO considers that, while no upfront compensation framework is likely to be perfect, risks of additional claims and inefficient process remain with the proposed unadjusted VWAP. The level of any methodology for upfront compensation should be considered in the context of the overall efficiency of the framework and seek to limit the burden of the additional claims process on both industry and AEMO. AEMO would welcome the opportunity to engage further with the AEMC to assess an approach that seeks to an appropriate balance in the level of upfront compensation.

Governance (recommendations 5, 6, 7)

AEMO supports the AEMC's recommendations to streamline the governance of compensation frameworks and considers these changes clarify and appropriately allocate responsibilities between AEMO, the AEMC and the independent expert.

- All compensation claims should be lodged with AEMO and agrees this should providing clarity to market participants and streamline the frameworks into one to reduce the overall cost to consumers.
- AEMO, using the independent expert function, should assess all claims for administered pricing compensation in addition to directions and market suspension compensation frameworks.
- All claims for opportunity costs should be assessed by the independent expert. AEMO agrees with AEMC, that while it should process and administer opportunity cost claims, AEMO is not best placed to conduct opportunity cost assessments, and this function is best allocated to an independent expert.

  Given the potential challenges involved in assessing opportunity costs at the commencement of the framework, AEMO may look to review and enhance our panel of independent experts to ensure that collectively they will have the necessary capabilities and capacity. It may also be worthwhile considering alternative or last-resort processes in the event the panel of independent experts does not have sufficient capacity to assess a high volume of claims.
- The Commission should retain responsibility for the guidelines for assessing opportunity cost claims. These guidelines will apply across all frameworks and AEMO would look to be actively engaged in the AEMC consultation to develop these guidelines to ensure their practical application.

Administration (recommendations 8-14)

AEMO supports the AEMC's following administrative recommendations, as set out below and considers these changes will support the effective operation of the frameworks by providing confidence to market participants that they will be compensated for services and in a timely manner. This in turn supports the efficient operation of the market by encouraging market participants to continue to provide services during periods of market stress.

- Administered pricing compensation should be assessed by trading interval within an eligibility period rather than by net revenue in an eligibility period.
- Administered pricing compensation should be assessed on an individual unit level rather than across all units that make up a claim for compensation.
- 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 both for participant application and supporting information, and time for AEMO assessment. We note that the Shortening the Settlement Cycle rule change may result in changes to the intervention settlement timetable and the 33 billing days referenced in the draft report may change. This will need to be accounted for when assessing time limits for claims.

  AEMO is conscious that while the timeframes should be met under all circumstances, there may need to be flexibility in the application of timeframes during periods of significant disruption (such as June 2022) where there may be a high volume of and/or complex claims. This could be worked through as part of Rules drafting, for example the Rules could require AEMO to advise the Australian Energy Regulator that it is unable to meet the obligation and then commit to another timetable that it can achieve.

- The same types of direct costs should apply to all compensation frameworks and be identified in a single list. Given that all compensation claims are linked to trading intervals, AEMO considers that the list of direct costs should explicitly include costs for the provision of services within the trading interval that are incurred outside of the trading interval (e.g. start-up costs).
- Cost recovery for administered pricing compensation should be determined on a trading interval basis, with costs recovered from the region where the price is set by the Administered Price Cap.
- Compensation for capacity directions should be recovered from consumers – however AEMO considers how this would work in practice needs to be carefully considered in drafting the rules. Capacity directions are not an explicit direction type under the NER and are covered under other compensable services directions.

  As noted above, other compensable services directions are currently used in practice as a catch-all where cost recovery is consistent across the category. The benefits of introducing sub-categories of directions in the NER should be carefully considered. It may be preferable to simplify and introduce flexibility into the compensable services direction's framework. AEMO would welcome the opportunity to discuss this further.
- The standard of information set out in the NER for directions and market suspension compensation is applied to the administered pricing compensation process. While participants may be best placed to comment on the recommendation for participants to submit information with a higher level of authority for sign-off, AEMO submits that the requirement for a higher level of sign-off should not be required if it materially increases the costs of or slows down the claims process.