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Dr John Tamblyn
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Dear John

COMPENSATION ARRANGEMENTS UNDER ADMINISTERED PRICING

Thank you for the opportunity to comment on Energy Australia's Rule Change Proposal, *Compensation provisions due to the application of an administered price, VoLL or market price floor*, lodged with the Commission on 10 December 2007.

Macquarie Generation does not support Energy Australia's proposal to amend Clause 3.14.6(e) of the Rules to limit the matters that the AEMC and the expert panel may take into account when considering the possible level of compensation payable to scheduled generators during an administered price period.

The Energy Australia proposal relies on the argument that generators could change their bidding behaviour following the triggering of administered price caps. Energy Australia asserts that generators would increase their offers for all or the majority of output, potentially up to the level of VoLL, as the NEM would effectively become a 'pay-as-bid' market with generators recovering their offer prices through the compensation process.

Macquarie Generation does not agree with the pay-as-bid argument. Once the cumulative price threshold has been triggered and the market enters an administered price period, NEMMCO will continue to dispatch the market on the basis of generator bids. Generators still face dispatch risk – the risk that competitors will offer lower priced output into the market to cover contract positions or earn spot revenue. Generators that intend to apply for compensation payments to recover costs in excess of the administered price cap must still compete for dispatch with generators in a similar situation. A generator that is not dispatched is not eligible for compensation.

The Rules as currently drafted require the AEMC to assess a fair and reasonable amount of compensation. The Commission must take into account the surrounding circumstances, the actions of relevant participants and NEMMCO, and the generator's dispatch offer. Generators are not guaranteed their offer price through the compensation mechanism. The uncertainty as to the quantum of compensation payable to individual generators, if any, means that there is price risk in addition to the dispatch or volume risk of pursuing a pay-as-bid strategy.

Macquarie Generation's main concern with the Energy Australia proposal is that it limits compensation to a strict list of direct costs – incremental fuel, maintenance and manning costs. Under the proposed drafting, the AEMC would not be able to consider other relevant costs incurred by a generator. This is a problem because administered price periods are likely to coincide with periods of tight demand and supply with potential risks to system security or reliability. Generators should have an incentive to offer all available plant to the market, including high cost plant and overload capacity.

Macquarie Generation considers that the AEMC should be able to use generator offers as a guide to the value of all direct and indirect costs incurred by generators during administered price periods. An accounting-based approach to the measurement of direct costs would fail to take account of a generator's opportunity cost of each additional megawatt offered to the market. This creates a regulatory risk for generators that would dampen the signal to make plant available.

Different types of plant incur costs that are not easily quantified but are implicit in a spot trader's offers to the market:

- coal plant – running coal plant at the 95% to 105% operating band will increase wear and tear on plant and equipment, for example through boiler tube erosion and fabric bag deterioration. The impact of accelerated wear and tear is not immediately measureable, but will limit plant availability and operating revenues in future periods when outages are brought forward;
- gas plant – increased production may result in the accelerated use of contracted gas supplies. This could result in lower gas availability during later dispatch periods when prices are no longer capped. In the longer term, in could result in higher prices when supply and transportation contracts are renegotiated;
- hydro plant – it is unclear how the AEMC could quantify the fuel costs for a hydro operator.

Macquarie Generation recognises that retailers face potential financial exposures if the AEMC determines that compensation is payable following an administered price period. Customers are reluctant to agree to contracts that allow the pass through of unknown levels of compensation. Similarly, there is not an active market for insurance products that could provide cover during these periods.

The best way of addressing Energy Australia's concern with possible losses from compensation payments is to set the administered price cap at a level that covers the costs of the marginal generating plant in most circumstances. Macquarie Generation argued in its submission to the current AEMC review of the schedule for the administered price cap that the current caps should be raised to $500/MWh during peak period and $100/MWh for off-peak periods. This increase in the cap would deliver a number of benefits.

It would:

- make the vast majority of financial contracts entered into by retailers effective during administered price periods;
- significantly reduce the likelihood that generators would need to pursue the recovery of losses through the compensation process;
- encourage generators to make plant available to the market during periods of likely system stress.

Macquarie Generation supports the NGF submission to this Rule change proposal. We would have no concerns with an amendment to the Rules that allowed the AEMC and expert panel to consider generator offers in the trading intervals prior to the enactment of administered price caps.

Yours faithfully

RUSSELL SKELTON
MANAGER MARKETING & TRADING

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