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10 December 2007

Dr John Tamblyn
Commissioner
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email: john.tamblyn@aemc.gov.au

Dear John,

Proposed changes to the National Electricity Rules
Chapter 3, clause 3.14.6 - compensation due to the application of an administered price,
VoLL or market floor price

In accordance with s.91 of the *National Electricity Law (NEL)*, EnergyAustralia requests the Australian Energy Market Commission (**AEMC**) to make a Rule change to the compensation provisions under the National Electricity Rules (**Rules**) following an event where the cumulative price threshold (**CPT**) is exceeded and administered price caps (**APC**) and floor are invoked in the National Electricity Market (**NEM**).

The purpose of this proposed rule change is to ensure that compensation to generators during an administered price period (**APP**) is based on their direct generating costs, rather than on their offer prices. The proposed rule change clarifies the roles of the AEMC and the expert panel, and the factors that must be taken into account, in relation to both the threshold question of whether compensation is to be awarded and the determination of a fair and reasonable amount. It also introduces a consultation process, whereby the AEMC must publish and receive submissions on a draft expert panel report and take these submissions into account in its determination.

EnergyAustralia has reviewed this matter in some detail and the attached Rule change proposal intends to address a number of issues with the current compensation provisions for scheduled generators under clause 3.14.6 of the NER:

1. **It is unclear how the criteria for determining compensation under clause 3.14.6 might be interpreted and applied by the expert panel and the AEMC, creating uncertainty as to how much compensation will be awarded.** The Rules are not clear on how compensation is to be calculated; giving the panel and the AEMC broad discretion in determining what is a 'fair and reasonable' amount. Possible outcomes range from zero compensation to compensation for the entire difference between the capped spot price and a generator's offer price.
2. **Awarding compensation according to offer price may affect market behaviour and outcomes in ways not envisaged or intended by the rule designers, rendering the spot price capping ineffectual and giving rise to high levels of compensation.** Offer-price-based compensation would create an effective "pay-as-bid" market, which academic literature suggests will compensate generators at a level similar to the uncapped spot price, rendering the APP/CPT arrangements ineffective and causing compensation payments to expand to make up the difference between capped and uncapped spot prices.
3. **Unlike normal spot market payments, the compensation payments under clause 3.15.10 are not able to be hedged, creating major risk and uncertainty for retailers and their customers.** A prudent retailer will have limited exposure to high spot prices, having entered into hedge contracts with generators, but is not likely to be able to arrange similar hedging against high compensation payments. Thus, the effect of the APP/CPT arrangements – particularly if pay-as-bid ensues – may simply be to turn hedged high spot prices into unhedged high spot prices, with consequential adverse impact on retailers and their customers.
4. **The process for determining compensation lacks transparency and does not clearly delineate the roles of the AEMC and the expert panel.** There is no opportunity for interested parties to be involved in the panel's deliberations or to be consulted before the AEMC makes a determination.

EnergyAustralia's proposed rule change removes much of the uncertainty over the criteria for determining compensation, by making it clear that the objective of the compensation is to ensure that a dispatched generator is able to recover its direct generating costs during periods of capped spot prices. It also better delineates between the two tasks of deciding on whether compensation should be awarded and determining the compensation amount.

EnergyAustralia believes by removing reference to offer prices in relation to generator compensation, the proposed rule substantially removes the possibility or risk that a pay-as-bid market may be created, or be perceived to be created, during an APP.

The proposed rule does not facilitate – and is not intended to facilitate – hedging of retailer compensation payments. However, by substantially reducing the risk of high levels of APP compensation, concerns associated with this issue are also substantially reduced. Estimates

of the magnitude of compensation payments and retailer risks under the current and proposed rules, as described in Appendix 1 of the rule change request, suggests that concerns about retailer and customer impacts are substantially addressed under the proposed rule.

Finally, the proposed rule addresses the transparency concerns by requiring the AEMC to consult with stakeholders on the expert panel report. The proposed approach is that the consultation is undertaken by AEMC – rather than by the expert panel – because the AEMC has the ultimate decision on the level of compensation to be awarded.

EnergyAustralia believes its proposed rule change will or is likely to deliver substantial economic benefits, in accordance with the NEM objective. Specifically by:

- Promoting efficient use of electricity generation capacity by ensuring efficient and secure dispatch during an APP, by removing the possibility of a pay-as-bid market and the related adverse impacts on the wholesale market;
- Promoting efficient investment in retail services by removing the possibility of extreme, unhedgeable compensation recovery charges being levied on retailers in the aftermath of an APP and so reducing the level of retail risk and so the retailer cost of capital;
- Promoting efficient retail prices by reducing the amount of risk capital that a retailer must hold to maintain solvency during a worst-case scenario (for example the triggering of an APP); and
- Promoting the long-term interests of consumers by removing the possibility of major customer disruption and hardship in the aftermath of an APP, which would result from retailers passing through the compensation costs to customers or from retailer insolvency.

Please find attached a detailed submission which provides background on the role of the compensation provisions, statement of issues concerning the existing rules, a description of the proposed rule and how it addresses the issues outlined above and how the proposed rule change contributes to achievement of the NEM objective. A draft of the proposed rule is provided in Appendix 2 of the rule change request.

EnergyAustralia would be pleased if the AEMC could give consideration to this matter. Should you require any further information or have any questions relating to this proposal, please do not hesitate to contact Philip Dixon-Flint, Regulatory Strategy Manager Wholesale on 02 9269 2317.

Yours sincerely,



Mike Bailey
Executive General Manager Retail