



# Australian Energy Market Commission

## Draft Amended Compensation Guidelines

### Explanatory Statement and Invitation for Written Submissions

9 June 2016

The Australian Energy Market Commission (AEMC or Commission) has prepared this Explanatory Statement to facilitate public consultation in respect of amendments made to the Compensation Guidelines that are developed by the AEMC in accordance with clause 3.14.6 of the National Electricity Rules (NER) (“Compensation Guidelines”). The Compensation Guidelines support the operation of clause 3.14.6 of the NER which prescribes how compensation is to be determined by the AEMC if a claim is made by an eligible party following the application of an administered price cap or administered floor price.

On 4 February 2016 the Commission made a final rule to amend the compensation arrangements following the application of an administered price cap or administered floor price.<sup>1</sup> Prior to the final rule commencing on 29 September 2016, the Compensation Guidelines are required to be amended.<sup>2</sup> In addition to the amendments required as a result of the final rule, other amendments and changes relating to opportunity costs have been made to the Compensation Guidelines. These additional changes reflect changing conditions in the market and provide additional clarity for eligible participants on the assessment and valuation of opportunity costs when submitting a compensation claim.

These amendments could impact the amount of compensation that would be able to be claimed by eligible participants under clause 3.14.6. Compensation is recovered from market customers.

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<sup>1</sup> *National Electricity Amendment (Compensation arrangements following application of an administered price cap and administered floor price) Rule 2016 No. 1*, 4 February 2016.

<sup>2</sup> New clause 11.84.2 of the NER, AEMC, *Final rule determination - National Electricity Amendment (Compensation arrangements following application of an administered price cap and administered floor price) Rule 2016*, 4 February 2016.

When developing or amending the Compensation Guidelines, the AEMC must follow the transmission consultation procedures (as set out in Clause 6A.20 of the NER).<sup>3</sup> The transmission consultation procedures require the AEMC to publish:

- this explanatory statement, which sets out the provisions of the NER under which the amendments to the Compensation Guidelines have been made and summarises the Commission's reasoning in making these amendments; and
- an invitation for written submissions on the proposed Compensation Guidelines.

The Commission invites submissions on the draft amended Compensation Guidelines by no later than **22 July 2016**.

### **Compensation mechanism during an administered price period**

The compensation arrangements in clause 3.14.6 of the NER are a component of the broader framework involving the market price cap, market floor price, cumulative price threshold, administered price cap and administered floor price. This framework helps to protect customers from extended periods of high prices.

The National Energy Market (NEM) is a gross pool, energy-only market. The potential for volatility of spot prices for both energy and ancillary services is an important aspect of the market design and operation. The ability of prices to move from -\$1,000 per MWh to \$13,800 per MWh<sup>4</sup> is designed to allow generators and other market participants to earn a return on assets and recover fixed costs, providing a signal for investment.

However, this volatility also creates risk for parties who participate in the wholesale market. A persistently high spot price can lead to participant financial distress and, in extreme cases, may impact the stability of the wider market.

The management of risk by individual market participants is an essential and unavoidable aspect of participating in the NEM. However, the NER contain a number of mechanisms which help to manage risks to individual market participants and systemic market wide risks posed by periods of sustained high prices:

- a spot market price cap and a market floor price which apply during the normal functioning of the market;
- a rolling cumulative price threshold that applies over a seven day period. The cumulative price threshold is currently set at \$207,000 and is calculated by the cumulative sum of spot prices in a region across a rolling seven day period.<sup>5</sup> If the total exceeds the cumulative price threshold, an administered price period commences in which the spot price is collared in the region between the

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<sup>3</sup> Cl 3.14.6(e) of the NER.

<sup>4</sup> As of June 2016, the market floor price was set at -\$1,000 per MWh and the market price cap was set at \$13,800 per MWh. From 1 July 2016, the market floor price will remain at -\$1,000 per MWh and the market price cap will increase to \$14,000 per MWh. AEMC, *Schedule of Reliability Settings*, 16 February 2016.

<sup>5</sup> As of June 2016, the cumulative price threshold was set at \$207,000. From 1 July 2016, the cumulative price threshold will increase to \$210,000. AEMC, *Schedule of Reliability Settings*, 16 February 2016.

administered floor price of -\$300 per MWh and the administered price cap of \$300 per MWh, and cannot exceed these limits for the entirety of the administered price period;<sup>6</sup> and

- a compensation mechanism for eligible parties who have incurred losses due to the application of an administered price period.

The application of the administered price cap may cause some participants to incur a loss where the participant's direct or opportunity costs are in excess of \$300 per MWh. The potential for them to incur a loss may create a disincentive to supply energy during an administered price period, particularly if opportunity costs are high. As a result of the amendments made to the NER by the final rule,<sup>7</sup> Participants will be able to submit a claim for a net loss incurred over the eligibility period.<sup>8</sup>

The AEMC is responsible for assessing claims for compensation following the application of an administered price cap and administered floor price.

### **Purpose of the Compensation Guidelines**

The Compensation Guidelines support the operation of clause 3.14.6 of the NER which prescribes how compensation is to be determined by the AEMC if a claim is made by an eligible party following the application of an administered price period.

The Compensation Guidelines provide guidance to:

- potential claimants and the Australian Energy Market Operator (AEMO) on the information required to be provided in support of a claim for compensation; and
- the Commission when determining whether compensation should be paid and the amount of compensation payable under the NER.

Under clause 3.14.6(n) of the NER, in making a final decision on a claim for compensation, the AEMC must apply these Compensation Guidelines unless it is satisfied that there are compelling reasons not to do so. This means that, in most cases it is likely that the AEMC would apply these Compensation Guidelines in making a final decision on a claim for compensation. However the AEMC is not bound to apply these Compensation Guidelines and there may be circumstances in which it is not appropriate for the AEMC to apply them in deciding on a claim for compensation.

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<sup>6</sup> The administered price period continues until the rolling seven day cumulative price threshold drops back below the level of the cumulative price threshold. The administered price period ceases at the end of the trading day in which the price drops below the cumulative price threshold.

<sup>7</sup> NER Clause 3.14.6 of the new rule is due to commence operation on 29 September 2016. AEMC, *Final rule determination - National Electricity Amendment (Compensation arrangements following application of an administered price cap and administered floor price) Rule 2016 No. 1*, 4 February 2016, p2.

<sup>8</sup> The eligibility period starts from the first trading interval when the spot price is set by the administered price cap or administered floor price, until the last trading interval of that day. NER Clause 3.14.6(a).

## Rules provisions

In this explanatory statement and the draft amended Compensation Guidelines, all references to clauses in the NER refer to the NER as amended by the rule made by the Commission on 4 February 2016.

Under clause 3.14.6(e) of the NER, the AEMC is required to develop and publish Compensation Guidelines that:

- define the types of opportunity costs in relation to which a person could make a claim under clause 3.14.6 of the NER;
- outline the methodology to be used to calculate the amount of any compensation payable in respect of a claim under clause 3.14.6, including the methodology for calculating direct and opportunity costs;<sup>9</sup> and
- set out the information AEMO and a claimant must provide to enable the AEMC to make a determination as to compensation under clause 3.14.6.<sup>10</sup>

Under clause 3.14.6(g) of the NER, the AEMC may from time to time, in accordance with the transmission consultation procedures, amend or replace the Compensation Guidelines.

## The review process to date

On 3 March 2016, the Commission published a Consultation Paper on proposed amendments to the Compensation Guidelines. No stakeholder submissions were received in response to this Consultation Paper.

## Assessment framework

The assessment framework the AEMC must follow for changes to guidelines is different from that for the assessment of changes to the NER. For changes to the NER, the AEMC must assess whether a proposed rule, will, or is likely to, contribute to the achievement of the National Electricity Objective (NEO),<sup>11</sup> as set out in Section 7 of the National Electricity Law (NEL).

This is distinct from the assessment of proposed changes to the Compensation Guidelines. Section 32 of the NEL provides that "in performing or exercising any function under this Law, the Regulations or the Rules, the AEMC must have regard to

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<sup>9</sup> NER Clause 3.14.6(e)(2).

<sup>10</sup> NER Clause 3.14.6(e)(3).

<sup>11</sup> The NEO is "to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to: (a) price, quality, safety, reliability and security of supply of electricity; and (b) the reliability, safety and security of the national electricity system."

the national electricity objective".<sup>12</sup> Therefore, in amending the Compensation Guidelines, the AEMC must have regard to the NEO.

As outlined in the Consultation Paper,<sup>13</sup> in order to have regard to the NEO the Commission will consider the following matters in assessing changes to these Compensation Guidelines:

- the reliability and security of the electricity system;
- the price of electricity supply; and
- transparency and regulatory certainty.

### **Consequential amendments to the Compensation Guidelines**

The final rule included a number of changes to the NER.<sup>14</sup> As a result, consequential amendments have been made to the Compensation Guidelines to reflect the final rule. Key elements of the final rule that have required changes to the Compensation Guidelines are:

- the incentive to invest in plant that provides services during peak periods has been removed from the purpose of compensation. The purpose of compensation has been clarified to reflect that it only relates to the provision of energy or ancillary services or consumption of load during an administered price period;<sup>15</sup>
- the eligibility criteria has been amended from a focus on compensation for the difference between an eligible participant's dispatch offer and the dispatch price in individual trading intervals, to an assessment of net loss over the eligibility period;
- eligibility for non-scheduled generators to make a claim for compensation has been included and eligibility for scheduled network service providers to make a claim for compensation has been clarified;<sup>16</sup>
- market suspension does not result in the application of an administered price period. Therefore references to the application of an administered price period following market suspension have been removed;
- references to market price cap and market price floor have been removed from the eligibility criteria as they occur during the normal function of the market, outside the constraints of the administered price period;
- the requirement for the AEMC to publish notices relating to a claim for compensation has been included;<sup>17</sup>

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<sup>12</sup> National Electricity (South Australia) Act 1996, National Electricity Law - Schedule, Section 32.

<sup>13</sup> AEMC 2016, *Review of Compensation Guidelines, Consultation Paper*, 3 March 2016.

<sup>14</sup> AEMC, *National Electricity Amendment (Compensation Arrangements following application of an Administered Price Cap and Administered Floor Price) Rule 2016 No .1*, 14 February 2016.

<sup>15</sup> The final rule clarified the references from 'other services' to 'ancillary services'. NER Clause 3.14.6(c).

<sup>16</sup> NER Clause 3.14.6(a)(3).

- the requirement for the AEMC to appoint an expert panel to advise on claims for compensation has been removed. Instead, the AEMC is provided with discretion to draw on external expertise, if required; and
- public consultation for direct cost only claims has been removed. Public consultation is only required for claims involving opportunity costs.<sup>18</sup>

## Amendments relating to opportunity costs

In addition to the consequential amendments to the Compensation Guidelines, further changes have been made in relation to opportunity costs, as outlined below. A key area of change is that a broader approach to opportunity costs has been taken to allow the Compensation Guidelines to respond to changing conditions in the energy market. In addition, additional clarity has been provided for eligible participants on the assessment and valuation of opportunity costs.

### Amending the definition of opportunity cost

In the current Compensation Guidelines, the definition of opportunity cost focuses on the foreclosure of opportunities to use scarce energy at another point in time.<sup>19</sup> Changing conditions in the NEM, for example relating to inertia and frequency control requirements in regions with a high proportion of renewables and embedded generation,<sup>20</sup> have highlighted that the current definition of opportunity costs appears too narrow. The current definition does not account for the foreclosure of more profitable alternative opportunities to use scarce resources in a *different market* during a price limit event<sup>21</sup> (i.e. same period of time).

In the amended Compensation Guidelines, the definition of opportunity cost has been changed to that outlined in the box below.

#### Definition of opportunity cost

*Opportunity cost is the value of the best alternative opportunity for eligible participants during the application of a price limit event or at a later point in time. The opportunity cost is the foreclosure of this alternative opportunity to use scarce capacity or resources more profitably at the same point in time or at a later point in time.*

Therefore, the definition of opportunity cost has been amended in the following way:

1. **Broadening the timeframe for an opportunity cost** – the definition of opportunity cost has been broadened beyond the foreclosure of future opportunities to also include the foreclosure of opportunities during a price limit event (same period of time); and

<sup>17</sup> NER Clause 3.14.6(j),(k) and (u)

<sup>18</sup> NER Clause 3.14.6(o)(3)

<sup>19</sup> AEMC, *Compensation Guidelines under Clause 3.14.6 of the National Electricity Rules, Amended Guidelines*, 17 February, p15.

<sup>20</sup> AEMC 2016, *Compensation arrangements following application of an administered price cap and administered floor price*, 4 February 2016, p32.

<sup>21</sup> A price limit event is when the dispatch price is set by the administered price cap or administered floor price during an administered price period, or when the ancillary service price is set by the administered price cap during an administered price period. NER Clause 3.14.6.

2. **Clarifying the type of scarcity and relevant markets** – the focus on the use of scarce energy has been changed to a focus on the use of scarce capacity or resources. The reference to “energy” in the current Compensation Guidelines is unclear. “Capacity” and “resources” are clearer terms. Capacity may be scarce if the available capacity that an eligible participant can provide to one market, instead of another market, is limited over a particular period of time.<sup>22</sup> Resources may be scarce if there are any limitations on the replenishment of these inputs, such as gas or water, which restrict output from an eligible participant over a particular period of time.

In proposing these changes to the definition of opportunity cost, the Commission has had regard to the NEO in relation to a price and security trade-off. While allowing compensation for opportunity costs at the same point in time may weaken the financial protection provided for consumers and market participants from the administered price cap, reduced incentives to provide services during an administered price period could contribute to reliability and security issues, which could also have costs for consumers. Therefore, it is considered more appropriate to maintain incentives to supply services, such as ancillary services, during an administered price period.

These changes may, for example, allow ancillary service providers to make a claim for opportunity costs based on the price difference between markets, where the energy price is uncapped, but the administered price cap applies to the ancillary service price. This relates to a situation in which an administered price cap is triggered in an ancillary service market and therefore applies in all ancillary service markets in the region, but not in the energy market.

#### **Amending criteria for assessing whether opportunity costs can be claimed**

In the current Compensation Guidelines, the criteria used to assess whether opportunity costs can be claimed is focused on whether a plant has technical or commercial limitations that may make it energy-constrained at a later point in time.

In the amended Compensation Guidelines, these technical and commercial limitations have been amended to reflect the new definition of opportunity cost, as outlined above. In addition, more information has been provided to explain what the AEMC would take into account to determine whether these limitations apply, including:

- a consideration of what the prevailing conditions were in the NEM, including the application or potential application of network constraints; and
- what the actual dispatch of the claimant’s plant was during the application of an administered price period.

In addition, in the amended Compensation Guidelines, the process that a claimant would need to apply in making a claim for opportunity costs has been clarified. The claimant would need to:

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<sup>22</sup> For instance, if a generator is procured to provide services to an ancillary services market during an administered price period, this may limit the amount of its capacity that could be supplied to the energy market over the same period of time.

- Firstly, demonstrate that its plant has scarce capacity or resources as a result of a technical or commercial limitation, and
- Secondly, calculate the value of the opportunity cost in the event that the claimant had chosen the more profitable alternative opportunity.

### **Amending the methods of valuing opportunity costs**

The current Compensation Guidelines provide that the choice of method(s) for valuing opportunity costs should follow a hierarchy of principles, as outlined below:

1. The preferred method is to use a market based valuation of opportunity costs;
2. If an appropriate market based valuation is not available then the claimant should consider using market values over a similar past period; and
3. If the use of market values over a similar past period is not available then the opportunity cost valuation should be based on processes and models used by the claimant.

An issue with the current approach is the lack of clarity on how to calculate the value of alternative opportunities. To address this, the Compensation Guidelines have been amended so that when a claimant applies valuation method 1, it would need to identify and take into account the relevant counterfactual(s) in calculating opportunity costs.

The counterfactual should be based on what would have occurred in the market had the claimant's behaviour changed and it had chosen the more profitable alternative opportunity. For example, a counterfactual should account for the potential impact on prices that occurred in the relevant market, if the claimant had supplied the volume of output that it claims it could have supplied to that market, over the particular period of time.

In addition, the amended Compensation Guidelines make changes to valuation method 3. The change clarifies that it is the claimant who should come up with another methodology, and that the AEMC will then assess this.

### **Other amendments to the Compensation Guidelines**

In addition to the amendments outlined above, other minor amendments have been made, including those below.

#### **Restructuring the Compensation Guidelines**

The Compensation Guidelines have been restructured to improve the ease of reading the guidelines. As a result, the numbering of most of the sections of the Compensation Guidelines is different from the current version of these guidelines.

#### **Clarifying claims by particular eligible parties**

Additional information has been provided on the types of scheduled network service providers that are eligible to make a claim for compensation (i.e. only market network service providers).

Additional detail has been included on the types of costs that could be claimed by ancillary service providers and the types of ancillary service providers that are eligible to make a claim for compensation. This proposed change has regard to the NEO in that it should improve transparency for eligible participants.

### **Amending the frequency with which the Compensation Guidelines are reviewed**

The current Compensation Guidelines state that, in practice, the Commission intends to review the Compensation Guidelines every three years, or at an earlier time, in light of market circumstances.<sup>23</sup>

Given the rarity of claims for compensation relating to the application of a price limit event in the past,<sup>24</sup> there does not appear to be a need to update the Compensation Guidelines every three years. Therefore, the Commission considers that it would be more appropriate to review the Compensation Guidelines only when there is a material change in circumstances.

### **Invitation for submissions**

The Commission invites written submissions on the draft amended Compensation Guidelines by 22 July 2016.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on market reviews.<sup>25</sup> The Commission publishes all submissions on its website subject to a claim of confidentiality.

Submissions should quote project number "EPR0048" and be lodged online at [www.aemc.gov.au](http://www.aemc.gov.au) or be sent by mail to:

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

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<sup>23</sup> AEMC, *Compensation Guidelines under Clause 3.14.6 of the National Electricity Rules, Amended Guidelines*, 17 February 2011, p3.

<sup>24</sup> There has only been one claim for compensation arising from such a period since the NEM commenced operation in 1998.

<sup>25</sup> This guideline is available on the Commission's website.