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Dr John Tamblyn
Chairman
Australian Energy Market Commission
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Your reference: EMO0007

Dear Dr Tamblyn

Proposed Compensation Guidelines - Establishment of First Compensation Guidelines

TRUenergy appreciates the opportunity to provide feedback on these Compensation Guidelines. The guidelines support the operation of clause 3.14.6 of the National Electricity Rules (Rules) which describe how compensation is to be determined by the Australian Energy Market Commission (Commission) if a claim is made by an eligible party following the application of an administered price, market suspension, VoLL or market floor price event.

The Commission's approach that provides compensation be recovered for both direct costs and opportunity costs by an applicant following an "event" is supported in principle. However, serious reservations remain regarding the broad spectrum of values that might be used as a proxy for the opportunity cost of energy for plants in category (a) were the Commission to adopt its current approach to determining this value. Under the Commission's approach, these plants would be free to propose the "traded value of a cap contract for a relevant time period and region" as a proxy for their opportunity cost.

TRUenergy offers the following comments in response to these guidelines:

1. The opportunity to claim the "traded value of a cap contract for a relevant time period and region" is not appropriate

The concept of using the traded value of a cap at any relevant time period and region as a proxy for the opportunity cost for plants in category (a) is inappropriate because it will allow these plants to "double dip".

It needs to be remembered that administered price caps are applied after a CPT event has occurred. The concept of the CPT is meant to allow sufficient time for capacity providers to make a reasonable annual return on capital before the administered price cap is applied. This approach balances the need to limit the risk of systemic financial collapse of the market against the need to ensure adequate incentives for provision of capacity to the market exist.

Cap contract premiums primarily compensate cap sellers for the market value of capacity. Hence if a cap premium was to be used to compensate an energy limited plant under an administered price cap situation, the plant would have likely already received a capacity return from the CPT event, and hence be receiving payment twice for the capital return requirement if compensated with a cap premium.

Similarly for compensation related to Voll events, it would be inappropriate to compensate with a cap premium - as the Voll (if adequately set by the Reliability Panel) should be sufficient to adequately compensate for capacity services.

Care must be taken to ensure that compensation methodologies are reflective of real commercial values to ensure that inefficient behaviour is not encouraged.

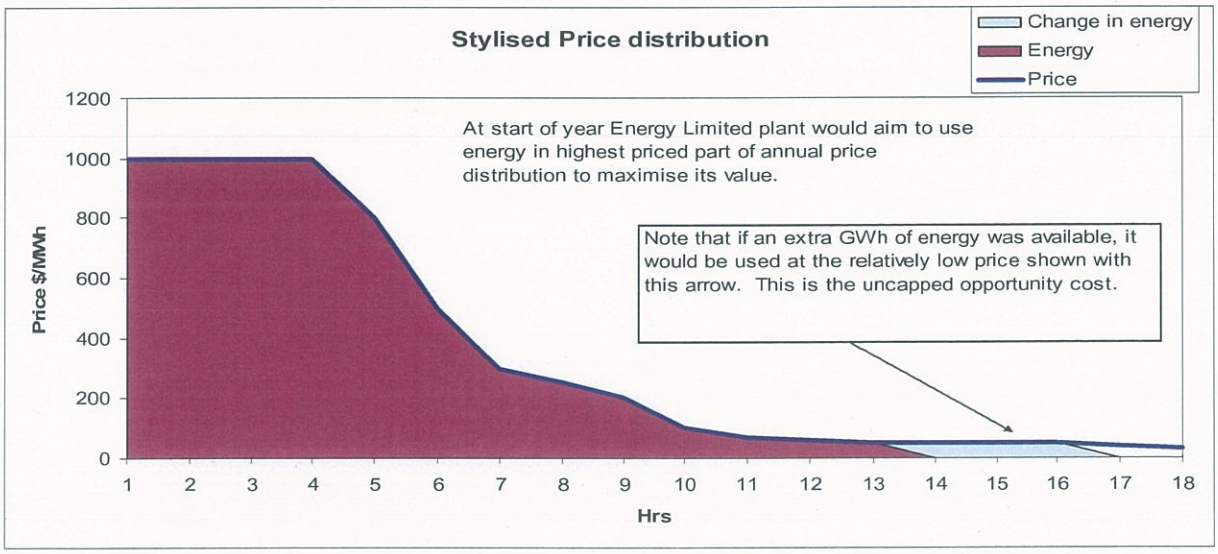
In this light using cap contracts as a basis for compensation is not appropriate. A more appropriate (and efficient) mechanism of determining opportunity cost for energy limited plants is outlined below.

2. The opportunity cost of energy for plants in category (a) should be based on a more robust and defendable economic methodology

The Commission needs to adopt an economic value for the opportunity cost of energy for category (a) plant that is robust and defendable in economic terms. We have serious concerns at the appropriateness of the values that might be achieved as a proxy for the opportunity cost of energy for this plant were the Commission to maintain the current draft approach. Accordingly, we recommend that the Commission gives serious consideration to the proxy for the opportunity cost of energy of this plant outlined below. We believe this proxy for opportunity cost is more economically efficient than the draft approach.

Graph A - Opportunity cost for energy limited plant in uncapped market

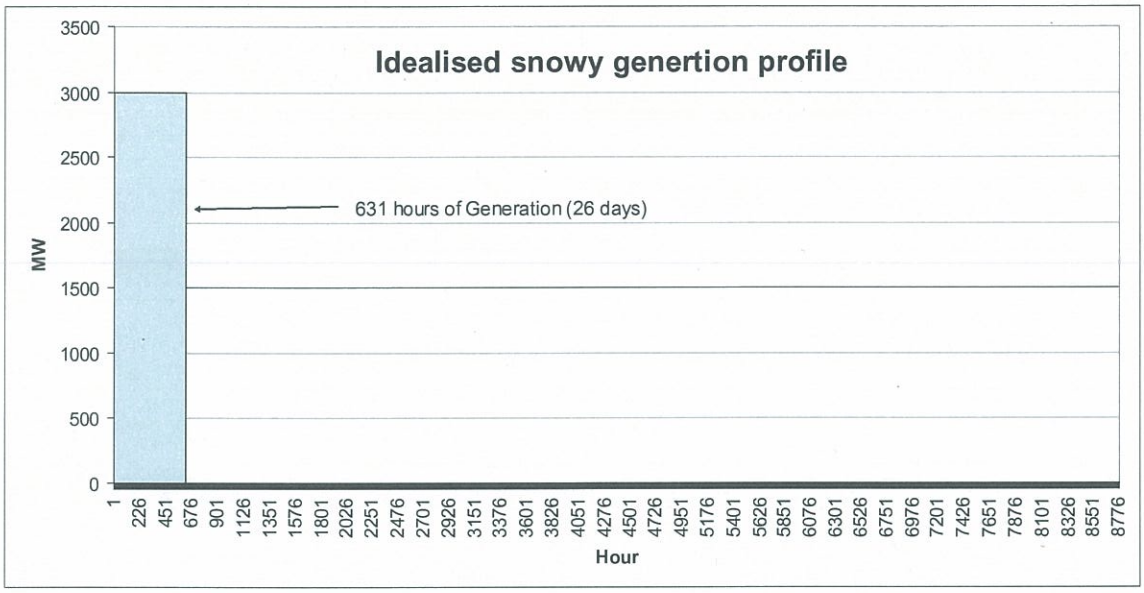
Graph A depicts the trend line that shows the distribution of prices in this market and the frequency of hours at which these prices are achieved. The "Y" axis represents the price achieved for energy per MW and the "X" axis represents the total number of hours at which that price is achieved. The value maximising strategy for an energy limited plant, would be to utilise its finite pool of fuel available during the period of highest price (this is shown as the red area on the graph). Importantly, the graph highlights that if the energy limit was relaxed the price that could be achieved for any additional MWh would be likely to be at the lower end of the price distribution (ie. shown as a blue area on the graph). The price which the additional energy could receive is the opportunity cost for this plant. The arrow in graph A demonstrates where this price would be.



While the above graph is a stylised format to demonstrate a point, it is worth considering what the cross over point for a more realistic NEM generator may look like. Graph A1 below shows an approximate

annual energy limit for the snowy scheme, and estimates how long it would take the scheme running at full load to use this energy (ie. 631 hours).

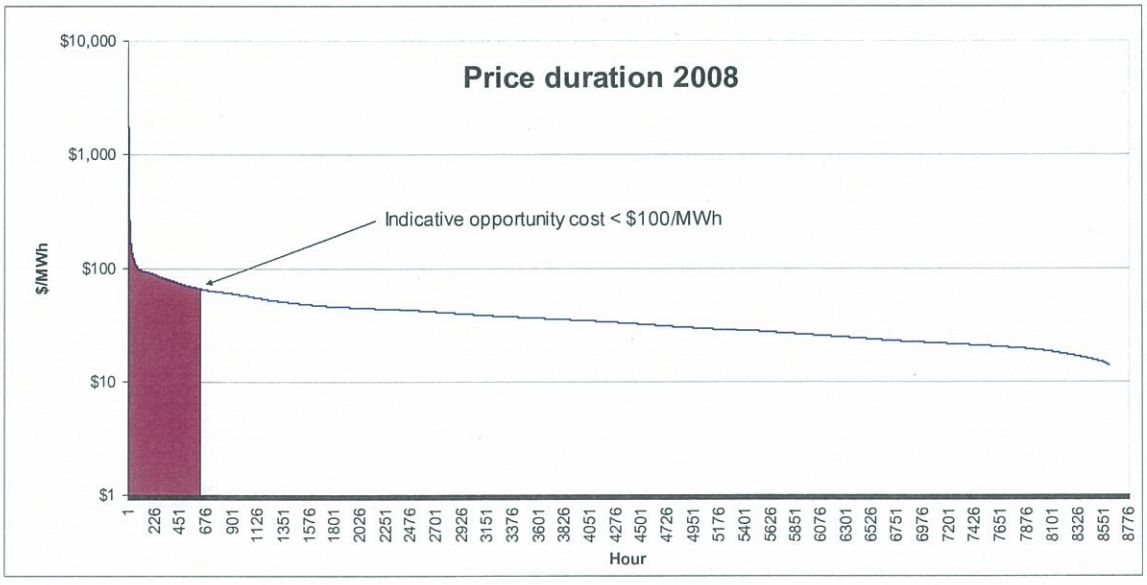
Graph A1 - Idealised snowy generation profile if all energy could be generated in max price hours



It is important to note that this is a theoretical mode of operation in which all the energy could be used to hit the top price periods. In reality all of this energy may not be completely discretionary, and it would be expected that the energy would be released over a much longer period. (Indeed more energy could be generated if pumping or other optimisations where used). Taking these realities into account, the estimate of 631 hours is likely to be a very generous estimate in terms of estimating an opportunity cost.

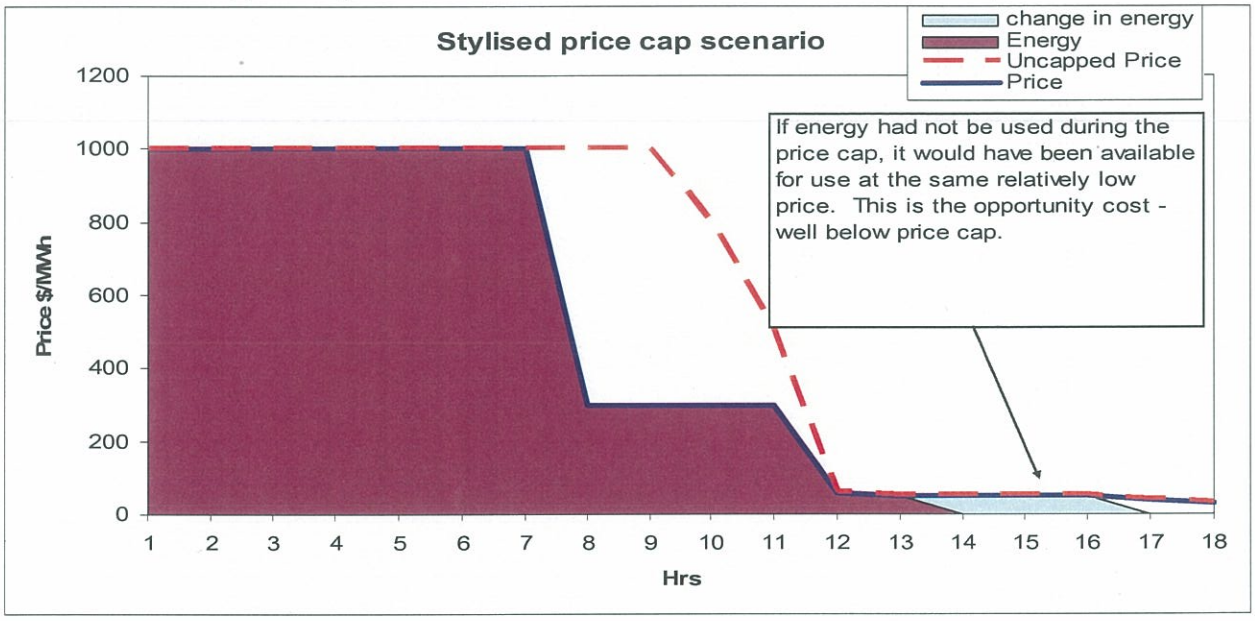
Graph A2 shows the actual price duration curve for 2008. The shaded area indicates the period in which the idealised energy limited plant in A1 would generate revenue (with perfect hindsight). The arrow shows the point at which the price curve intersects with 631 hours. It can be noted that this opportunity cost is well under $100/MWh (which in turn is well under the administered price cap). As noted in the preceding paragraph, a more realistic energy production profile would push this intersect point to the right of the graph - and hence reduce the opportunity cost.

Graph A2 - Idealised opportunity cost for energy limited plant in Graph A1



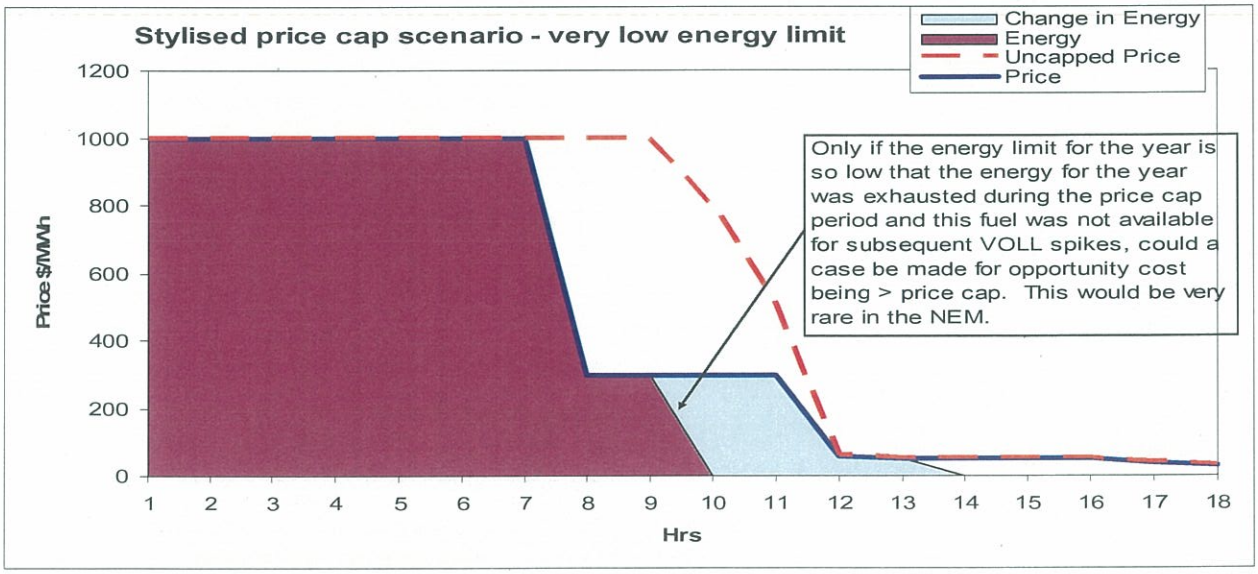
Graph B - Opportunity cost for plant in capped market - Typical NEM scenario

Graph B - whilst similar to graph A- depicts a stylised scenario in which an administered price cap is imposed (in hrs 9, 10 and 11). Similarly to Graph A, the price achieved for any additional MWh of energy available to this plant (ie. the opportunity cost) is shown by the arrow pointing to the blue area. Clearly, under his scenario, the opportunity cost is likely to be well below the price cap, and no compensation would be required for energy produced during the capped period. We would expect that this scenario would be the case under the majority of situations in the NEM. The arrow in graph A demonstrates the opportunity cost.



Graph C - Rare scenario where opportunity cost may exceed the price cap

Graph C depicts a scenario under which the energy limit for the plant is so severe (or the price capped period is so long) that the annual energy available to the plant is exhausted during the period in which the price cap persists. Again, a blue area on the graph is used to illustrate the value that could be ascribed if the energy limit could be relaxed. Only under this extremely rare situation, may an opportunity cost in excess of the price cap be justified (and hence compensation be payable). Even under this condition, an opportunity cost in excess of the price cap could not be guaranteed, and could only be justified if prices in excess of the price cap are considered highly likely following the removal of the administered price. We would expect that this situation would be very unlikely in the NEM.



Proposed opportunity cost compensation approach

In the light of the above evidence, we believe a more appropriate estimate of the opportunity cost of an energy limited plant would be to use the average of the pool price capped at $300/MWh (ie. an underlying energy value) achieved in the market over the previous 5 years. This would provide a more realistic proxy for the opportunity cost for an energy limited plant taking into account the factors discussed above. Using a 5 year average is appropriate as it takes into account that fact that for hydro plants actual energy limits will vary from year to year with climatic conditions, and that this should smooth out any anomalous market events to some degree.

We note that it is proposed that an expert panel would be instituted to oversee any contentious compensation claims. This would allow plants that find themselves subject to the scenario under Graph C, or who can justify that a 5 year average is not appropriate the opportunity to make their cases.

It may be worth setting up the 5 year average as a default approach, and having the panel as an optional appeal mechanism. This would minimise the costs of administering the scheme, in the event of non-controversial claims.

Costs of expert panel may be excessive

We also understand the expert panel would be drawn from the dispute resolution panel. We note this is likely to be excessively expensive for typical claims, and suggest that a single independent expert akin to what is used under compensation for direction claims should be considered as a more efficient mechanism (noting that disputes can always be initiated if the expert determination is contentious).

3. If the Commission permits the use of the traded value of a cap to be used as a proxy for the opportunity cost of energy during an "event" then it should use caps priced in the market before the event occurred.

As outlined above, the proposal to use the traded value of a cap at any relevant time period and region as a proxy for the opportunity cost of plants in category (a) is inappropriate because it is likely to result in inefficient and excessive compensation payments.

In addition, the market for traded caps in the NEM is relatively illiquid and maintains a scarcity value even before an extreme market event takes place. In many circumstances, the occurrence of a significant market event causes a reaction in the cap contract market (typically an increase in cap value may be expected).

If, despite our misgivings outlined above, the AEMC determined to continue down the path of using a cap premium in its compensation calculations, we would urge a premium set well prior to the given administered price cap event should be used to provide a valuation of market capacity that is not biased by any particular market stress event that may have recently occurred and on which the claim for compensation is being based.

4. Only uncontracted energy should be compensated in the case of opportunity costs

It would only make sense to compensate generators (under the opportunity cost limb) for uncontracted capacity that is required during a price cap. This is because generators have already received compensation (via contract) for capacity that is contracted, and in fact they will be experiencing relief from their contractual commitments by virtue of the administered price (ie. they will be relieved from having to fund difference payments above the price cap). To allow for further compensation for such contracted capacity would further add to the potential inefficiency of the compensation scheme.

Of course direct costs, such as fuel and accelerated O&M should be compensated as these direct costs are incurred irrespective of whether a plant is contracted or not.

Participants seeking compensation for opportunity costs should be required to justify that they are uncontracted for the capacity on which they are seeking compensation, and that they are only seeking compensation in relation to capacity exposed to the pool.

We would be pleased to clarify any of the above. To initiate such discussions, please contact me via (03) 8628 1000.

Yours sincerely,

Mark Frewin
Manager Wholesale Market Regulation