



8 July 2011

**The Chairman  
Australian Energy Market Commission  
Level 16, 1 Margaret Street  
SYDNEY NSW 2000**

By email to [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au)

Dear Chairman,

**Review of arrangements for Compensation following an Administered Price Cap,  
Market Price Cap or Market Floor Price - EPR0023**

AGL Energy (AGL) welcomes the opportunity to comment on the Australian Energy Market Commission's Compensation Guidelines.

Retailers are significant stakeholders in the compensation process as the compensation payable is to be recovered from Market Customers in the affected region. AGL has a significant customer base and therefore will be required to fund a large portion of any compensation paid to generators.

The compensation guidelines form part of the CPT and APC scheme which aims to prevent financial failure of market participants as a consequence of continued high prices which result from involuntary clearing of the market. As a market distortion, it must minimise the additional costs to participants.

During the design of the administered price capping mechanism there was a clear need to balance the competing needs of participants that needed *force majeure* protection<sup>1</sup> and those whose assets could be involuntarily consumed during the administered price period. This balance was to be achieved by:

- ensuring that participants were able to recover their capital costs for peaking plants prior to the imposition of the administered price; and
- allowing compensation for participants who were involuntarily dispatched at a price below the price at which willing to offer the plant to the market.

The primary consideration during the design of the compensation scheme was to prevent a party rebidding their offers above the Administered Price when they knew they would be dispatched, thus gaining unfair compensation, while ensuring a party that truly suffered from the involuntary dispatch gained fair compensation. (It had not occurred to us that a party would be paid compensation if their offer price was below the administered price, particularly if they rebid to lower their offer).

In the remainder of this document, we address these issues in more detail.

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<sup>1</sup> The provisions were established to replace the *force majeure* provisions that existed in the Code at that time.

### The competing objectives of the Cumulative Price Threshold (CPT)

The objective of the Cumulative Price Threshold (CPT) is to provide a risk management mechanism for extreme events which result in high prices, without influencing the voluntary clearing of the market at other times.<sup>2</sup>

In energy only market generators rely on periods of high prices so that in the long run they can recover their LRMCS'. This is considered in the establishment of the CPT so that prices, prior to the application of the APC are, in theory, sufficiently high to increase forward contract prices to allow participants to recover their fixed costs, either through forward contracts or the pool and to encourage investment. (The establishment of the CPT requires the establishment of an appropriate balance between competing objectives, of financial failure of the market due to high prices resulting from extreme events and facilitating new investment.)

The intention is that the CPT should only be breached in the event of a market failure where supply fails to meet demand, i.e. an event such as a transmission failure or significant event or externality beyond the markets "normal" operating envelope. However as price caps do not discriminate between "involuntary clearing" and other high priced events it is highly likely that the CPT will be applied in a situation where demand is high and involuntary clearing has not occurred. AGL notes that in the case of the Synergen compensation claim, the market was continuing to clear voluntarily, and the CPT was breached due to continuing high prices where supply in SA exceeded demand.

The "Objective of paying compensation" as described in Section 5 of the Guidelines and 3.14.6 of the Rules<sup>3</sup> states that in preparing the guidelines the AEMC must;

- "(1) identify the objectives of the payment of compensation under this clause as being to maintain the incentive for:
- (i) *Scheduled Generators, Scheduled Network Service Providers and other Market Participants to invest in plant that provides services during peak periods; and*
  - (ii) *Market Participants to supply energy and other services during an administered price period;"*

AGL believes there is an inconsistency between the stated objective that the payment of compensation is to encourage investment and the calculation of compensation which is based on the recovery of the costs directly incurred and the opportunities forgone by participants when the spot price payable is less than their dispatch offer.

As the Commission notes;

*"This compensation regime is just one component of the market's broader MPC-Cumulative Price Threshold (CPT)-APC mechanism, which, as a whole, provides a comprehensive framework to provide investment signals and manage risks faced by retailers and other market participants."*

As described above the broader frame work has two objectives;

- Maintain investment signals  
With respect to the maintenance of investment signals the MPC and CPT are set so that they should not prevent peaking generators from recovering sufficient revenue on an annual basis before the CPT is reached to retain the incentive to invest.
- Manage risks faced by participants  
The APP period commences to manage market participants' risk, compensation is provided to generators where necessary to recover costs directly incurred to facilitate the continuing supply of energy.

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<sup>2</sup> NECA Reliability Panel VoLL and the cumulative price threshold – Issues paper December 2003, Pages 13 & 40

<sup>3</sup> NER Chapter 3 Page 186

It is questionable then that an objective of receiving compensation should be to provide investment signals as this is inconsistent with the risk management objective. During the APP compensation is funded by retailers/consumers which results in an unhedgeable risk for those participants compensation be based on costs directly incurred by the claimant and the value of any opportunities forgone, to the extent they are greater than pool revenue.



In AGL's view it is the broader (CPT) – APC mechanism which meets both of the above objectives i.e. 3.14.6 (c) (1) (i) and 3.14.6 (c) (1) (ii).

However with respect to 3.14.6 (c) (1)(i), AGL believes it is not the intention that the payment of compensation will provide an incentive for Scheduled Generators, Scheduled Network Service Providers and other Market Participants to invest in plant that provides services during peak periods. The objective of paying compensation is only to maintain the incentive for Market Participants to supply energy and other services during an administered price period, i.e. 3.14.6 (c) (1) (ii)

In AGL's view the objective in the Rules and the guidelines should be clarified accordingly.

#### The competing objectives of the application of the Administered Price Cap (APC)

The efficiency objective of the application of the Administered Price Cap (APC) and Administered Floor Price, (AFP) is to avoid efficiency losses associated with high prices, and low prices respectively, that can result when there is a lack of competitive tension and the market is clearing involuntarily.

The intention in applying the cap (or floor) is to avoid the efficiency losses that would result from continuing high (or low) prices.

However as a countervailing efficiency objective, the administered price needs to be set so as to signal to all supply and demand the scarcity of electricity to facilitate market participation. The compensation provision recognises that, to manage risk, the APC may be set such that some generators variable costs are higher than the price cap, and these generators will need to be compensated to maintain the continuing supply of energy.

Consistent with the risk management objective the total of market revenue and compensation will not exceed the identifiable costs of the participant in maintaining supply during the application of the period of the administered price cap and floor.

#### Eligibility to claim compensation

Clause 3.14.6 A) determines the eligibility for scheduled generators' to claim compensation

3.14.6 (a) *Scheduled Generators may claim compensation from AEMO in respect of generating units if, due to the application of an administered price cap during either an administered price period or market suspension, the resultant spot price payable in respect of the dispatched generating units in any trading interval is less than the price specified in their dispatch offer for that trading interval.*<sup>4</sup>

A scheduled generator is eligible for compensation if during an administered price period the spot price payable in any trading interval is less than the price specified in their dispatch offer for that trading interval.

It is clear that in an APP eligibility is to be determined at each trading interval and that if a generator wishes to be compensated in that dispatch interval their dispatch offer must be greater than the spot price (which is capped at \$300).

This incentivises cost reflective offers during an APP to promote continued efficient operation and to minimise compensation. This is consistent with the normal operation of the market.

There appear to be two alternative ways of interpreting this provision which depend on the meaning of the term "dispatch offer".

#### A rebid is a dispatch offer.

This in AGL's view is a correct interpretation of the Rules and is consistent with normal operation of the NEM.

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<sup>4</sup> Clause 13.4.6 of the NER

(In the Rules a rebid is defined<sup>5</sup> as a variation to a dispatch offer.)

In this case if a generator is dispatched during an APP the variation to the dispatch offer for that trading interval would be compared with the spot price to determine eligibility as described above.

A rebid is not a dispatch offer.

This is the interpretation made by the Panel and the AEMC.

In this case if a generator is dispatched during an APP the original dispatch offer would be compared with the spot price to determine eligibility.

The Panels interpretation is based on the objectives of the compensation provisions;

*"to maintain the incentive for:*

- (i) Scheduled Generators, Scheduled Network Service Providers and other Market Participants to invest in plant that provides services during peak periods; and*
- (ii) Market Participants to supply energy and other services during an administered price period;"<sup>6</sup>*

and the National Electricity Objective (NEO in the NEL),

*"The objective of this Law 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"<sup>7</sup>.*

Based on the above the Panel's concludes that, in the unusual circumstances of an APP, the Rules as correctly interpreted give priority to reliability and security of supply and that the need to minimise the cost of supply is a secondary objective.<sup>8</sup>

As discussed previously AGL is of the view that the objective of paying compensation is not to maintain the incentive for participants to invest and it is incorrect for the Panel to be relying on this objective to support their view that reliability of supply has a higher priority during an APP.

AGL therefore sees no basis either in the NEO or the objectives of paying compensation for treating reliability as a higher priority during an APP than at any other time of high prices.

The Panels argument in summary appears to be that, although the competitive market is normally the means by which the NEM objectives (efficient prices and reliable supply) are met<sup>9</sup>:

- The notification of an APP and the imposition of an APC necessarily modify or distort normal operation of the competitive market,
- An APP occurs in periods of high stress when reliability of supply is at risk,

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<sup>5</sup> **rebid** A variation to a bid or offer made in accordance with clause 3.8.22.

**generation dispatch offer** A notice submitted by a *Scheduled Generator* or *Semi-Scheduled Generator* to AEMO relating to the *dispatch* of a *scheduled generating unit* or a *semi-scheduled generating unit* in accordance with clause 3.8.6.

<sup>6</sup> Expert panels Recommendations to the Australian Energy Market Commission Assessment of Synergen's Compensation Claim Pursuant to Clause 2.14.6 of the National Electricity Rules – Section 3.2.

<sup>7</sup> *ibid* Section 3.2

<sup>8</sup> *ibid* Section 3.2 "AGL submits that, if "dispatch offer" were read as "dispatch offer as modified by subsequent rebids" then this would serve to minimise compensation payable and ultimately serve to provide the least cost outcome for consumers. The Panel's answer to this point is that, in the unusual circumstances of an APP, the Rules as correctly interpreted give priority to reliability and security of supply"

<sup>9</sup> *ibid*– Section 3.2 "While a competitive market is normally the means by which the NEM objectives are achieved, a competitive market is not itself a NEM objective. Further, while efficient prices are a NEM objective, so also are reliability and security of supply. The balance between these objectives in a particular situation depends upon the Rules governing that situation."

- In the unusual circumstances of an APP the Rules give priority to reliability and security of supply.



The Panel has therefore interpreted the meaning of dispatch offer during an APP so that any generator whose original dispatch offer for that trading is greater than the pool price in that trading interval during an APP is eligible for the payment of compensation.

As AGL has noted and the Panel has agreed this has undesirable consequences<sup>10</sup>

Further although the interpretation of dispatch offer applies to dispatch offers made by all generators it is only relevant to generators whose SRMC (or whose costs in a trading interval) are greater than the APC \$300/MWh, i.e. those generators who are entitled to compensation. It is therefore not clear to AGL that it is open to the Panel to make this interpretation of the Rules because:

- In considering the impact of the rule on the efficiency of the dispatch mechanism, it is clear that it provides a benefit<sup>11</sup> to some generators by releasing them from revealing their true costs in making their offers and as a result imposes a cost on other participants, creates inefficient outcomes and therefore economic efficiency is most likely to decrease by this interpretation, and
- This rule is clearly about modifying the behaviour of some participants at certain times. Interpreting the NEM as defined in the NEL s2 means that the AEMC is limited in its power under s 34(1) (a) (i) to making rules in relation to regulating the operation of the "wholesale exchange operated and administered by AEMO" and the "national electricity system". That is the AEMC is not empowered to make Rules generally regarding the behaviour of sellers and buyers within the wider economic or wholesale market.

The objectives of the payment of compensation under this clause are to maintain the incentive for Market Participants to supply energy and other services during an administered price period;"

We do not agree that the Rules, through the objectives for the payment of compensation give a higher priority to reliability and security of supply during an APP over reliability at other times. The balance to be made here is between the countervailing objectives of managing risk and maintaining the incentive to supply. The interpretation by the Panel is unnecessary and is inconsistent with the risk management objective.

Further the interpretation of the dispatch offer being the rebid (a rebid is defined as a variation to a dispatch offer) in the relevant trading interval encourages generators to make offers consistent with their true costs which can provide an important yardstick in a compensation regime where costs which form the basis of the compensation are confidential.

We do not agree that the notification of an APP and the imposition of an APC necessarily modify or distort normal operation of the complete market. The only change that occurs

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<sup>10</sup> Ibid Section 3.2 "AGL submits that the Panel's interpretation of "dispatch offer" (which it incorrectly characterises as a modification of the Rules rather than interpretation of the Rules) has certain undesirable consequences. These include the fact that a Generator which has been dispatched may rebid at lower prices to ensure that it is dispatched for all remaining trading intervals of the APP, knowing that it will be compensated. AGL submits that this consequence is undesirable because it enables Generators to rebid below their efficient costs, and absolves them from minimising operational and start up costs at the ultimate expense of consumers. The Panel acknowledges that the consequences which AGL describes may occur during an APP but is of the view that this is the compromise which the Rules as currently framed are designed to achieve. During an APP, priority is given to reliability and security of supply of energy.

<sup>11</sup> Allows High SRMC plant (peaking plant) to be dispatched ahead of lower SRMC plant and therefore provides an economic benefit to peaking plant in the wider market.

is that in the settlement process pool payments are capped at \$300. The Rules require that all the dispatch processes remain unchanged.<sup>12</sup>

This assumption that reliability will be increased appears to be predicted on Synergen's claim that their reliability will be enhanced by allowing their high cost plant (SRMC > \$300) to operate continuously during an APP i.e. avoid shut downs and start ups.

The panel has not demonstrated why (providing compensation is paid) reliability is more at risk during an APP than during high priced events which are not due to an APP. Further it has not demonstrated why during periods of high prices making a dispatch offer at a very low or negative price increases reliability any more than making a dispatch offer at a plant's SRMC.

This change disadvantages reliable peaking plant compared to plant that may be less reliable and reduces the incentives for maintaining the load following performance of peaking plant.

The change also increases the scope of the eligibility criteria to include a wider range of plant. Any plant where the original dispatch offer is greater than a price in a subsequent dispatch interval and has costs greater than the pool revenue will be entitled to compensation. This could occur as prices decrease towards the end of the APP or if there is price volatility with low or negative prices during an APP.

In our view there is only one interpretation of the meaning of dispatch offer i.e. as dispatch offer includes rebids or variations to dispatch offer. If the Commission is of the view that reliability of supply will be under threat during an APP then an alternative solution to the current arrangements should be considered.

AGL is of the view that the circumstances in which compensation is paid should be minimised which for example could be achieved by:

- Increasing the APC so that it greater than the SRMC of the highest SRMC plant, or
- Implementing a rule change which limits the application of the APC to physical plant or equipment failures (such as transmission failures) which create high prices. We note that the NGF previously submitted a Rule change proposal with this objective. The proposal was rejected by the Commission, in our view on spurious grounds.

AGL has provided responses to the questions raised by the Commission in Appendix 1.

Should you have any questions in relation to this submission, please contact Alex Cruickshank, Manager Energy Markets Regulation, on (03) 8633 6026 or at [acruicks@agl.com.au](mailto:acruicks@agl.com.au).

Yours sincerely,



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<sup>12</sup> NER clause 13.4.2(d) "During an *administered price period* the procedures for *PASA, dispatch, spot price* and *ancillary service price* determination are to continue in accordance with the provisions of the *Rules*."



## Responses to the Questions

### **Question 1: Are there any additional matters that should be included in the scope of the review?**

AGL is not aware of any additional matters that should be included in the scope of the review.

### **Question 2: What is the purpose of paying compensation under clause 3.14.6 of the Rules?**

Please refer to the above discussion. The purpose of paying compensation is to maintain the incentive for Market Participants to supply energy and other services during an Administered Price Period (APP).

### **Question 3: Do the objectives of paying compensation as currently set out in the Rules accurately reflect the policy objectives that the compensation provisions were, or should be, designed to achieve? If not, what should the objectives be?**

The objectives of paying compensation as currently set out in the Rules do not accurately reflect the policy objectives of the compensation provisions. Please refer to the above discussion on the competing objectives of the application of the Administered Price Cap (APC).

The objective of the APC is to manage the risk of financial failure of the market at times of continuing high prices and the object of the compensation provisions is to ensure that during an APP the incentive for Market Participants to supply energy and other services is maintained by compensating participants whose costs of operation are greater than the revenue received without unduly imposing additional costs on other participants.

### **Question 4: In the case of multiple and/or competing objectives, what is the appropriate balance to be struck between them?**

Please refer to the above discussion in relation to the competing objectives of the;

- Cumulative Price Threshold (CPT), and the
- Administered Price Cap (APC)

AGL is of the view that the balance between the normal operation of the market and the management of the risk of financial failure of the market should be established by the Reliability Panel.

However regulatory intervention should be minimised so that the circumstances in which compensation is paid are also minimised, which for example could be achieved by;

- Increasing the APC so that it greater than the SRMC of the highest SRMC plant, or
- Implementing a rule change which limits the application of the APC to physical plant or equipment failures (such as transmission failures) which create high prices. We note that the NGF previously submitted a Rule change proposal with this objective. The proposal was rejected by the Commission, in our view on spurious grounds.

### **Question 5: Do the objectives of paying compensation suit all of the different participants and circumstances in which compensation is payable.**

Given the constraint that the APC is necessary to manage risk the objectives of paying compensation suit the circumstances in which compensation is payable, however are unlikely to suit all the different participants because some participants (those with variable costs greater than the revenue received) recover only the cost of operation while others (with low variable costs) will recover their variable costs and a contribution to fixed charges.



**Question 6: In what circumstances should persons be eligible to apply for compensation, having regard to the objectives of paying compensation?**

Participants should be eligible for compensation during an APP when their offer or rebid for a trading interval is greater than the pool price in that trading interval.

**Question 7: Should the references to “market suspension” be removed from clauses 3.14.6(a), (a2) and (b)? If not, why?**

AGL is not aware of any reason why the references to “market suspension” should remain in clauses 3.14.6(a), (a2) and (b).

**Question 8: Are there any other issues in respect of the criteria for eligibility to apply for compensation that would benefit from further consideration in this review?**

AGL is not aware of any other issues in respect of the criteria for eligibility to apply for compensation that would benefit from further consideration in this review?

**Question 9: In light of the confidentiality issue and other issues discussed in this Issues Paper, is the AEMC the most appropriate body to be assessing compensation claims of this nature?**

There could be some advantage in making the assessment of compensation for directions and during administered price periods more consistent. It is more important, however, to correctly define the basis for compensation. If that is done, the mechanism becomes less important and could be passed to AEMO for administration.

In its original form, the assessment of compensation for involuntary dispatch during periods of administered price caps was a matter of fairness more than amount. For this reason, a panel process was chosen. If the rule is simply to be procedural then AEMO may be a better choice.

**Question 10: Is it necessary in all instances to appoint a three person Panel to assess a claim brought under clause 3.14.6? If not, what is a more appropriate arrangement?**

The use of a three person panel was intended to allow a mix of skills and market experience to be applied, like that used for scheduling errors. Given that the issue of capital cost recovery was dealt with during the period before administered prices applied, the only matter was to ensure that if involuntary dispatch was required a party would be compensated.

The primary consideration during the design was to prevent a party rebidding their offers above the Administered Price when they knew they would be dispatched, thus gaining unfair compensation, while ensuring a party that truly suffered from the involuntary dispatch gained fair compensation. (It had not occurred to us that a party would be paid compensation if their offer price was below the administered price, particularly if they rebid to lower their offer) A panel therefore seemed appropriate.

If the rule is sufficiently clarified to make it a mechanical task then the use of a panel in all (or any) cases may no longer be appropriate.



**Question 11: Should the Commission be required to notify the market that it has received, and/or has formally commenced consideration of, a claim under clause 3.14.6?**

The Commission should notify the market that it has received a claim for compensation to allow those participants who are likely to be funding the compensation as much time as possible to assess the impact of the claim on their future revenues.



**Question 12: Should some flexibility be built into the timing associated with processing a claim to provide for information gathering, delays or extensions?**

AGL is of the view that claims should be made and processed promptly. Including flexibility for information gathering and processing increases the risk of significant delay in reaching resolution.

**Question 13: What aspects (if any) of the provisions set out in clause 3.15.10 would benefit from further consideration in this review?**

AGL refers the Commission to the letter from the NGF to the Commission dated 10 December 2010 (regarding the consultation on the compensation guidelines), which identified a number of apparent errors in clause 3.14.6.

These inconsistencies will need to be addressed in this consultation.