

Australian Energy Markets Commission (AEMC)

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1 September 2022

Submission to AEMC ERC0347 National Electricity Market Amendment (Amending the Administered Price Cap): Consultation Paper

The Australian Energy Council welcomes the opportunity to make a submission to the AEMC ERC0347 National Electricity Market Amendment (Amending the Administered Price Cap): Consultation Paper (Consultation Paper).

The Australian Energy Council (AEC) is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

The AEC considers the current \$300/MWh Administered Price Cap (APC) to be the market setting that prevented the market from functioning during the recent Administered Pricing Period (APP) of June 2022¹. Figures 5.2 and 5.3 in the Consultation Paper clearly illustrate with \$42/GJ delivered gas prices, 7,000 MWs of derated dispatchable thermal generation has a Short-Run-Marginal-Cost (SRMC) at the current APC. At an APC of \$600/MWh (proposed by Alinta) this reduces to just under 3,000 MWs to 3,500 MWs. Accordingly, the AEC supports Alinta's rule change proposal to increase the APC to \$600/MWh for at least a 12-month period and that it be an expedited rule change process.

However, the AEC believes the other issue with the current APC is that it has not been indexed to inflation. As noted in our submission to the Reliability Panel (The Panel), consideration should at the very least be given to escalating the APC by inflation to retain its real value.² Furthermore, since the current APC was set in 2008 significant changes have occurred in the east coast gas market (eg, commissioning of three LNG export terminals).

Assessment Framework

The AEC believes the rule change proposal satisfies the NEO and broadly supports the AEMC's approach. The AEC is however attracted to the Framework applied in the AEMC's 2008 review of the APC set out its approach in a much simpler manner.

"Taking submissions and the NEO into account, the Commission formed the view that the APC level should strike a balance between the following competing objectives:

- *mitigating the risk of a systemic financial collapse of the electricity industry during an extreme market event;*
- *minimising compensation claims by market participants following an application of the APC;*
and

¹ More information on how the APC contributed to the June power system crisis can be found here:

<https://www.energycouncil.com.au/analysis/aemo-market-suspension-report-anatomy-of-a-crisis/>

² <https://www.energycouncil.com.au/media/ltaijack/20220707-aec-submission-to-rel0082-2022-rss-review-final.pdf>

- *minimising the incentives for market participants to not supply electricity during administered price events.*³

The recent crisis has demonstrated that the current APC fails to satisfy the second and third requirements.

Administered Price Cap (APC) History

The NEM commenced in 1998 and very rapidly \$300 cap contracts evolved to manage risk. The logic at the time was based on the physical characteristics and costs of generating a MWh using liquid fuel. Hence, a peaking generator selling caps could manage risk by generating even if operating on liquid fuel. From April 1998 until 2008 the APC was \$100/MWh at peak times and \$50/MWh in off peak times. Hence, the APC did not meet \$300 caps. Rather it was actual generation costs in 1998.

In 2008 the AEMC conducted a review of the APC and decided to increase it to \$300/MWh.⁴ This was a comprehensive review, based on contemporary evidence and resulted in an APC that had plenty of margin for error. In 2008 gas prices across the NEM ranged between \$4/GJ to \$5/GJ.⁵ This contrasts with the level of consideration given to the APC in the Reliability Panel's recent draft determination which recommended maintaining \$300/MWh.

In 2008, the AEMC noted that a \$300/MWh APC only represented three per cent of the Value of Lost Load (VoLL)⁶ price at the time (\$10,000/MWh). Currently, the APC represents 1.9 per cent of the Market Price Cap (MPC). The 2008 review also considered which generators had SRMCs above \$300/MWh. The combined capacity of these generators was then only 177MW. Although it needs to be noted that these SRMCs were based on prevailing fuel prices and all the plants were liquid fuel. Hence there was no stress testing with extreme fuel (gas and liquids) prices. Gas may have been neglected because the analysis was many years prior to the commissioning of the Queensland LNG export trains which exposed the Eastern Australian gas market to international prices, increased supply pressure and prices.

With respect to updating the APC, the AEMC recommended at a minimum three-yearly reviews in lieu of indexation. The AEC however considers that the periodic reviews subsequently conducted by the Reliability Panel did not substantively meet this recommendation.

With the passage of time a mistaken view has arisen that has linked the APC level to the financial market's use of \$300 strike price in cap contracts. However, in reality the APC was set based on physical characteristics not financial. This current disconnect has allowed the APC to continue at its current level without any consideration of the physical realities and its level has been conflated with a financial product. In colloquial terms, 'the tail has been wagging the dog'. The APC may have even hindered the evolution of financial products to more accurately manage risk in the market by creating a perception of a link between the two. The decline in the real value of the APC has resulted in hedgeable price risk moving to unhedgeable compensation risk, which is left for consumers and otherwise prudently contracted retailers to bear.

Commodity prices outlook

The AEC believes the APC should be reflective of what potential gas prices can attain and the gas APC. The ACCC's 16 August 2022 LNG netback price series report indicates forward prices above \$60/GJ until March

³ <https://www.aemc.gov.au/sites/default/files/content/b8c0bbc2-013a-490b-a70a-a04618f5ec1c/Final-Determination.pdf>

⁴ <https://www.aemc.gov.au/sites/default/files/content/b8c0bbc2-013a-490b-a70a-a04618f5ec1c/Final-Determination.pdf>

⁵ http://www.qca.org.au/wp-content/uploads/2019/05/22649_DD-ER-NEP910-ACIL-DraftDecBRCI-Report-1208-3.pdf

⁶ Since renamed to Market Price Cap

2024. Whether or not these prices eventuate this risk cannot be ignored and the AEMC should be mindful of this when considering the level of the APC.

Apportionment of Risk

The current APC level assigns an inappropriate level of risk that can't be hedged with retailers and consumers particularly large customers that have pass through provisions in their contracts. As described above, market circumstances have changed significantly since 2008 and when accounting for inflation since then the current APC is \$218/MWh in real terms ie, (2008 dollars). The proposed \$600/MWh APC is \$436/MWh in 2008 dollars. While higher than the APC determined in 2008, as argued above there have been both structural and (possibly) transitory changes in fuel markets that justify the APC increasing in real terms. Figure 1 illustrates how this risk allocation has changed over time and how the proposed APC is likely to realign it.

Figure 1: Real \$2008 APC and unhedgeable risk allocation over time

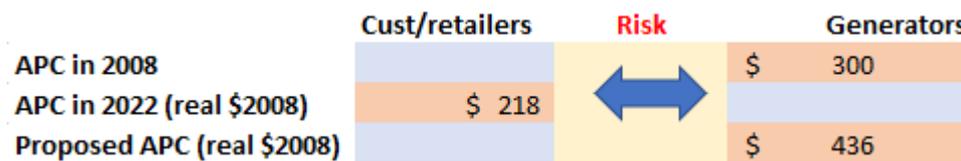
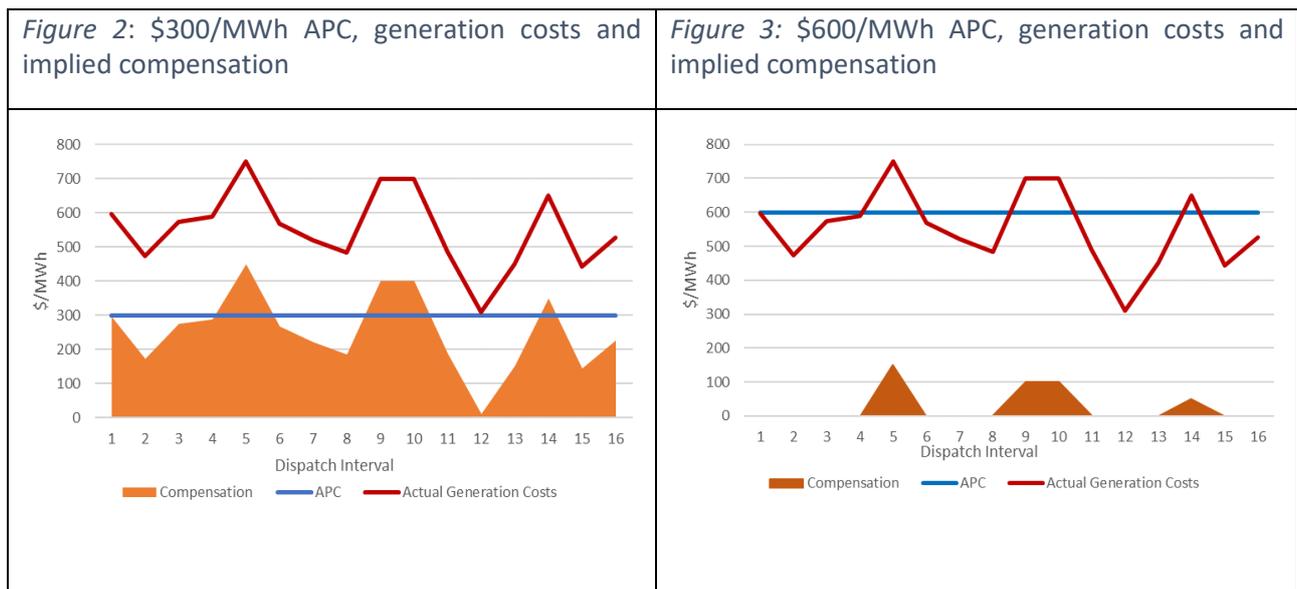


Figure 2 illustrates a basic example how generator compensation would be calculated with the \$300/MWh APC. The excess of the actual generator costs above the APC will be a critical determinant for the level of compensation for that dispatch interval that will have to be passed on to retailers and ultimately consumers. Figure 3 applies the same actual generation costs (from Figure 2) series to a \$600/MWh APC. As would be expected compensation payments are far lower hence the less unmanageable risk allocated to retailers and consumers. The reduction in dispatch intervals where generation costs exceed the APC also reduces administrative burden on industry and market bodies (ie, AEMC and AEMO).



Cumulative Price Threshold (CPT)

The level of the APC was the critical matter that led to the June 2022 crisis. In the context of the urgent consideration of the temporary arrangements proposed by Alinta, it is reasonable for the AEMC to not address CPT. However, when time permits, the AEC believes that the APC should not be considered in isolation and that the CPT level should also be considered. Whilst fortunately, unlike the APC, the CPT has been indexed, there is a prima facie case that it is insufficiently high for today's market.

Contract market implications

The AEC suggests that, to the extent time permits, the AEMC consult on a confidential basis with market participants as to how a higher APC will affect the results of their risk and pricing models. This should ensure that when the AEMC makes its final decision it is aware of what if any implications their decision is likely make on the price of risk in the NEM.

Any questions about our submission should be addressed to Peter Brook, by email to peter.brook@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'P Brook', is displayed on a light yellow rectangular background.

Peter Brook

Wholesale Policy Manager
Australian Energy Council