1 September 2022

Anna Collyer
Chair
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted online: www.aemc.gov.au

Dear Ms Collyer

Amending the administered price cap – Consultation Paper

Origin Energy Limited (Origin) welcomes the opportunity to provide comments on the Australian Energy Market Commission's (AEMC) Consultation Paper on Amending the administered price cap (APC).

Origin is supportive of increasing the level of the APC to better reflect underlying fuel price relativities for marginal plant, consistent with the rationale for the proposed rule and findings of the Reliability Panels 2022 Reliability Standard and Settings Review (RSSR).

As noted by the AEMC, the APC is intended to be set at a level that minimises financial stress in the market while also incentivising the provision of sufficient supply during administered pricing periods (APPs). Recent events have demonstrated that a disconnect between higher fuel costs and the current level of the APC does not allow for adequate balancing of these objectives. Fuel prices are now higher on average and more volatile relative to historic levels that would have been considered when the APC was set at $300/MWh in 2008. Gas / electricity markets are also becoming more interlinked as the NEM transitions towards higher levels of VRE, heightening the need to ensure pricing relativities between those markets are adequately accounted for when determining the level of the APC.

Where the APC remains below optimal levels, we agree it is likely to impede efficient market operations and expose market customers to ad-hoc costs associated with compensation claims for directed participants that are difficult to hedge, noting the Australian Energy Market Operator (AEMO) directed close to 5 GW of generation capacity on 15 June 2022.[1] A lag in cost recovery under existing annual retail price setting processes may also increase the potential for retailer distress when coupled with higher wholesale prices.

Our views on determining an appropriate level for the APC, and other issues identified by the AEMC, are discussed below.

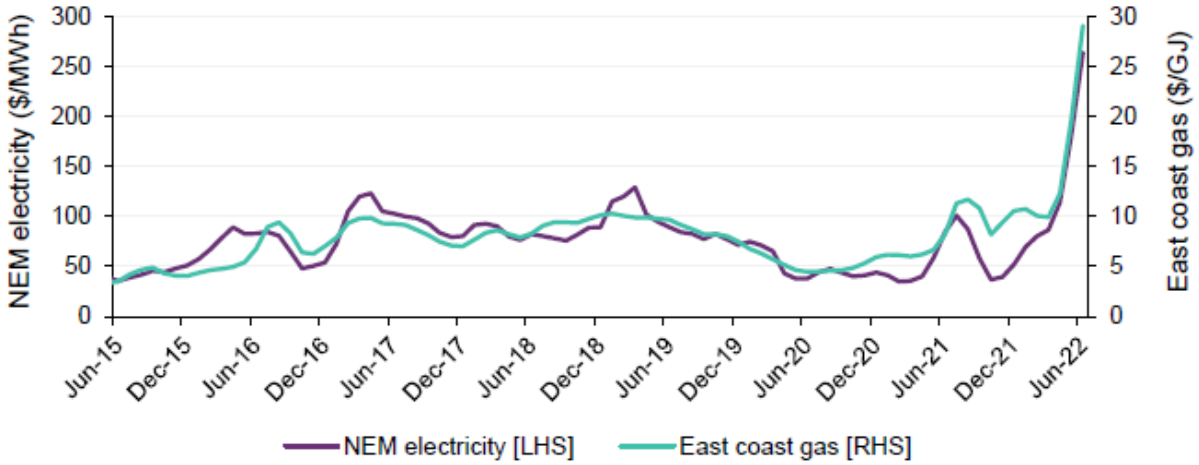
1.Determining an appropriate APC – the level should better reflect potential fuel price relativities for marginal plant

[1] AEMO, 'NEM market suspension and operational challenges in June 2022', August 2022, pg. 31.

To support efficient NEM operations, the APC should be set at a level that would incentivise sufficient supply during an APP and by extension, minimise the need for AEMO to direct participants, while also helping to insulate market customers from extreme and prolonged periods of volatility.

Raising the APC from its current level to better reflect the underlying fuel costs of gas-power generation (GPG) is appropriate in this respect. Chart 1 below outlines the strong relationship across time between movements in east coast gas market prices and NEM wholesale spot prices, reflecting the role of GPG as a key marginal supply source in the NEM. While hydro generators are also a crucial source of supply, the AEMO has noted the marginal price setting role played by hydro may reflect more flexible 'opportunity cost'-based pricing of underlying water reserves, whereas GPG offer pricing is more constrained by actual fuel costs.[2]

Chart 1: NEM wholesale spot and electricity prices and east coast wholesale gas prices (rolling three month averages)[3]



To determine a suitable level for the APC, the AEMC should consider the short-run marginal cost (SRMC) of a representative (benchmark) open cycle gas turbine (OCGT) plant based on an appropriate heat rate and fuel cost. This is consistent with the principle that the APC is not intended to cover the costs of all NEM generators, with some allowance for additional compensation claims, including opportunity costs.

In contemplating an appropriate fuel cost, as suggested by Alinta, a reasonable approach could be to assume a gas price equivalent to the APC in the Short Term Trading Market (STTM) / Declared Wholesale Gas Market (DWGM). This is on the basis that during extreme periods, the gas market APC is likely to provide a reasonable indicator of the marginal cost of fuel. This would be preferable to more dynamic approaches that result in the APC varying with changes in underlying fuel costs, which would increase complexity and uncertainty for market participants. It would also generally improve pricing relativities between gas and electricity markets during APP events. To account for any further changes in fuel costs over time, the electricity and gas APCs could be indexed going forward, consistent with the market price cap (MPC) and cumulative price threshold (CPT) in the NEM.

This approach broadly aligns with the analysis underpinning the Reliability Panel's APC recommendation. The Reliability Panel estimated the SRMC of thermal plant based on $400/MT and $40/GJ coal and gas prices respectively and determined an APC of $500/MWh should cover the SRMC

[2] AEMO, 'Quarterly Energy Dynamics Q2 2022', July 2022, pg. 20.
[3] Ibid, pg. 16.

of most generators under a range of scenarios. By comparison, an OCGT heat rate of 12 GJ/MWh (which is a reasonable general assumption)[4] and $40/GJ fuel price corresponds to an SRMC of $480/MWh.

The AEMC notes one of the alternate approaches that could be considered would be to establish an APC structure that varies across different time periods (e.g. peak and off-peak periods). Such an approach could notionally strengthen supply incentives for storage providers in extreme periods where the spot price remains at the APC for extended periods, as it would ensure there is always an opportunity for arbitrage between peak and off-peak periods. However, to ensure consistency with the Reliability Panel's recommendations, any changes to the structure of the APC would likely be best considered in subsequent RSSR processes, rather than through a temporary rule change process.

2. Contract market implications – any impacts are likely to be limited in practice

In general, Origin does not consider increasing the APC would materially impact the contract market. The level of the APC is not a primary driver of hedging requirements or cap contract premiums, given such events are highly infrequent and represent a small proportion of profit / loss scenarios that would typically inform risk management approaches of prudent retailers. As noted by the AEMC, any impact on credit support / margining requirements is therefore likely to be minor relative to the overall increase in funds already required due to elevated energy / contract prices currently. Further, while there is potential for a change in the APC to trigger market disruption clauses in some OTC contracts with a $300/MWh strike price, we do not expect this to be a limiting factor provided market participants are allowed sufficient time (i.e. at least one month) to renegotiate any revisions to those contracts.

Having regard to the above, it is important to note that revising the APC (as proposed) is intended to improve the ability of retailers to manage costs during APPs and reduce pricing uncertainty for customers by minimising exposure to ad-hoc compensation claims that are difficult to hedge. Where this is achieved, the benefits of revising the APC should outweigh any associated costs, with the Reliability Panel noting that on balance there are material benefits to increasing the APC to minimise reliance on the compensation regime.[5]

3. Period of application – the revised APC should apply up until 1 July 2025

A revised APC should remain in place until 1 July 2025 to align with the commencement of the Reliability Panels recommended change, and ideally align (or at least not exceed) the level recommended by the Panel (i.e. $500/MWh). This approach is consistent with the view that the current level of the APC is no longer fit for purpose and should be revised on an enduring basis. It would also avoid any potential disruption / uncertainty associated with reverting back to a lower APC at the conclusion of the temporary period.

As noted above, it would also be prudent to provide a minimum notice period of at least one month prior to any change taking effect to allow participants sufficient time to manage any disruption to existing contracts.

4. Cumulative price threshold – commensurate changes are not required / appropriate

Origin does not consider there is a need to revise the level of the CPT in conjunction with changes to the APC as part of this process. As discussed above, increasing the APC should assist with addressing the underlying issue identified and facilitating more efficient market operations during APP events. Increasing the CPT could have a material impact on the level of risk for market participants, given it

[4] ElectraNet, 'General Technical and Cost Parameters', Document prepared by Aurecon, 23 July 2020, pg. 7.
[5] AEMC Reliability Panel, '2022 Review of the Reliability Standard and Settings – Final Report', 1 September 2022, pg. vi.

effectively sets an upper limit on prolonged exposure to the MPC that typically informs retailer / market customer hedging requirements. Changes to the CPT should be progressed through the RSSR process and apply from 1 July 2025 (as recommended by the Reliability Panel) to ensure participants have sufficient lead time to manage the associated change to their risk profile.[6]

If you wish to discuss any aspect of this submission further, please contact Shaun Cole at shaun.cole@originenergy.com.au or on 03 8665 7366.

Yours Sincerely,

Steve Reid
General Manager, Regulatory Policy (Acting)

[6] Ibid, pg. 75.