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Australian Energy Market Commission

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Amending the administered price cap

Pacific Energy Trading appreciates the opportunity to respond to Alinta's rule change regarding changes to the administrative price cap.

Pacific Energy Trading is opposed to the rule change. Out-of-cycle changes to the Administrative Price Cap and the Cumulative Price Threshold will impose significant short- and long-term costs on consumers, without properly addressing the threat to system security identified by the rule change request.

The withdrawal of generation capacity after the APC period began was very troubling and has led to widespread dissatisfaction with the electricity market. Rather than reacting quickly to popular narratives, it's worth re-examining the events that led to that outcome.

The June 2022 APP event

Much of what has been written about the workings of the APC and CPT in the wake of the events in June has been misguided. The CPT exists to protect market participants from periods of heightened market stress and reduce the probability of financial collapse and contagion. It achieves this goal by reducing the total cost of energy supply, by temporarily capping the marginal price paid to all generation. Increasing the APC will decrease this financial protection and significantly disrupt the contract market, where a huge number of contracts and systems are linked to the existing price cap.

Generators dispatched at prices below their short-run marginal cost during an APP are eligible to receive compensation for their additional costs. The total cost of energy will be lower even once this compensation is taken into account, as compensating a small number of high-cost generators is cheaper than having those generators set the marginal price for all generation in the NEM. AEMO estimates that the APP and market suspension events saved consumers \$686 million in wholesale energy costs¹.

¹ See <https://aemo.com.au/newsroom/media-release/nem-suspension-costs-lower-than-expected> and <https://aemo.com.au/newsroom/news-updates/aemo-ceo-speaks-at-the-clean-energy-summit> . AEMO estimates consumers saved \$800m in wholesale energy costs, less \$114m in intervention and compensation costs.

It has been asserted that the withdrawal of generation in June was an unforeseen consequence of the APP mechanism; however, the potential for prices to fall below generators' short-run marginal cost during APP and market suspension periods has long been recognized and was the impetus for the participant compensation following market suspension rule change, due to the South Australian system black event in 2017². This rule change specifically foresaw the need to compensate generators for excess fuel costs during market suspension events. Given this compensation regime, it is unlikely that generators withdrew capacity as a result of high fuel prices.

Consistent with this, AEMO's Q2 Quarterly Dynamics³ and Market Suspension reports⁴ both indicate that the majority of generation capacity withdrawn during the APP in June didn't have fuel costs close to the APC. Rather, the capacity removed – most of which is controlled by a single participant – was facing fuel supply constraints.

Under normal dispatch, energy constrained generators can change their offer prices and volumes to adjust how much energy they produce and at what price. There is no reason why this cannot be achieved during an APP, provided other generators continue offering to supply the market at prices close to their short-run marginal costs. If, instead, as we saw in June, other generators rebid their capacity to very high price bands, it becomes difficult for energy constrained generators to manage their output through normal bidding. Under such circumstances, these generators may be justified in withdrawing capacity in order to ration energy over time, though we would suggest this could have been done in such a way that lessened the risk to system security.

As AEMO's Market Suspension Report suggests, planned and unplanned outages, combined with high demand and low variable renewable generation, saw the NEM rely heavily on energy constrained generation throughout May and June, putting pressure on coal stockpiles and other forms of energy storage. A number of these generators appear to have seen the APP as an opportunity to reduce their generation and relieve their energy constraints, and consequently rebid their capacity to higher price bands. A small group of generators without fuel constraints appear to have done the same as a form of "protest" against the imposition of the APP. It would be worthwhile for the AER to investigate and analyse the rebids of relevant participants during this period before any rule changes are made.

Once one generator has rebid in this manner, it is difficult for other energy constrained generators not to follow suit without placing further pressure on their limited energy resource. While new to the NEM, this type of "race-to-the-top" repricing is common during periods of stress in energy systems dominated by energy constrained generation. During the APP, it reduced the effectiveness of the dispatch price signal provided by the ROP – the shadow price calculated by AEMO - leaving some energy constrained generators with no choice but to withdraw their capacity entirely, to avoid further depletion of their scarce resource.

The suggested rule change will not resolve or address this issue. Increasing the APC will not prevent generators from rebidding to higher price bands during an APP and nor will it prevent generators from withdrawing capacity. Indeed, as energy storages are further depleted, the incentive to withdraw capacity will only increase further. While it may seem appealing to ameliorate this problem with a price signal, the APC isn't the price that needs to be examined – rather, it is the ROP that needs remain intact in order for dispatch to continue appropriately during periods of market stress. As a short-term

² <https://www.aemc.gov.au/rule-changes/participant-compensation-following-market-suspensi>

³ <https://aemo.com.au/-/media/files/major-publications/qed/2022/qed-q2-2022.pdf?la=en&hash=73DC1623997128E30EB3F6EBFD2E5AAC>

⁴ <https://aemo.com.au/en/energy-systems/electricity/national-electricity-market-nem/nem-events-and-reports>

measure, generators must be compelled to bid in good faith in all circumstances, so that the price signal provided by the ROP retains its effectiveness during APP and Market Suspension periods.

In the longer-term, more work is required to explore the operation of the NEM as an energy constrained market, rather than a capacity constrained market. As the NEM shifts further towards a system dominated by variable renewable generation, supported by energy constrained hydro and batteries, it is possible to envision a situation where these issues arise under normal circumstances, rather than just during APP and Market Suspension periods. This is because no mechanism exists in the NEM to manage the rationing of energy across time periods with the same price, apart from the rebidding of availability.

The Administered Price Cap

The level of the administrative price cap has remained fixed since the beginning of the market. Many risk and IT systems reference it, and it matches the strike for market-standard capacity contract of \$300/MWh. In normal times, well-telegraphed changes to the level of the APC are expected to have a small impact on the contract market. However, as the rule change request indicates, these are not normal times, and nor would any change in the level of the APC be well-telegraphed. In the present situation, with a heightened level of risk in the market, a short notice change to the level of the APC is likely to have an abnormally large impact on the level and liquidity of the contract market.

As of 26/8/22, the outstanding open interest in ASX \$300-strike cap contracts is 14,675MW, and the notional value of these contracts is in excess of \$1.4bn. This doesn't account for the large volumes of OTC contracts not traded on the exchange. All of these contracts were entered into on the basis of the existing level of the APC and any changes may necessitate a disorderly adjustment in hedge levels, hampering liquidity and increasing costs for consumers.

It has been suggested that increasing the APC may enable simpler cashflow management for retailers, as compensation would comprise a lower portion of total energy costs. While no effort has been made to quantify this effect, it would appear to be rather small in comparison with the increased energy costs, as AEMO's estimate for total energy costs during the June APP and Market Suspension events shows. In any case, enabling retailer cashflow management will not benefit consumers directly, while diminished liquidity and increased contract prices will result in a real increase in costs.

Beyond those immediate impacts, changing the level of the APC in response to short term drivers will set a negative precedent for the market and put a needless obligation on the AEMC to continually monitor opaque fuel supply markets and adjust the level of the APC accordingly. Unfixing the APC like this will add uncertainty into the appropriate price for capacity contracts, particularly those maturing beyond the proposed sunset clause for this rule change. Again, this uncertainty will increase market hedging costs.

Furthermore, increasing the APC in the present circumstance creates a significant moral hazard – it shows the generators that they can achieve their regulatory goals by withdrawing supply.

The Cumulative Price Threshold

It is our view that changes to the cumulative price threshold should be considered separately from changes to the APC and outside of the expedited rule change process.

The level and operation of the CPT are more impactful than changes to the APC. Increases in the level of the CPT will reduce the supply of capacity contracts available to the market, increase participant hedging costs and increase the overall wholesale cost of energy. Depending on the magnitude of the

change, the increases in costs could be very large. Furthermore, temporary changes to the CPT will increase uncertainty in the market and make longer-term contracting more difficult. Given this, and the lack of clear relationship between the cumulative price threshold and the issue this rule change aims to address, it is worth treating any changes to the CPT with caution.

The suggestion that the cumulative price be calculated using the capped RRP rather than the ROP is misguided. It is again worth considering the original purpose of the CPT, which is to protect the market from widespread default events. While the APP in June had a number of causes, it is easy to imagine a simpler event triggered by and primarily impacting one or two large participants. For example, one large participant may suffer widespread unplanned outages across their generation portfolio, resulting in a high level of price volatility, triggering an APP. To prevent the collapse of that participant and subsequent cascading defaults, it is sensible that the APP should continue until that participant's generation capacity returns to service. This is achieved by having the cumulative price tied to the ROP.

Conclusion

Pacific Energy Trading is opposed to out-of-cycle amendments to the administrative price cap and altering the level or operation of the cumulative price threshold. More analysis is required of generator rebidding during the APP and Market Suspension periods, but, at this stage, it doesn't appear that the APC was a driving factor. In the longer-term, further work is required to examine the operation of the NEM during periods of energy scarcity.

If you would like to discuss this submission, please contact Tom Waye at tom.waye@pacificenergytrading.com.au.

Regards,

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Trader

Pacific Energy Trading