



7 January 2008

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

Dear Sir or Madam,

**Joint TRUenergy and AGL submission to clarification of schedule of Administered Price Cap**

Please accept the attached comments to the review of the schedule of the Administered Price Cap on behalf of the TRUenergy and AGL companies. The submission is not confidential.

AGL and TRUenergy consider that the Administered Price Cap schedule should be set at \$500 for both peak and off-peak periods, with a regular adjustment for increases based on relevant price indicators.

Yours Sincerely,

A handwritten signature in black ink, appearing to be 'Ben Skinner', written over a horizontal line.

Ben Skinner  
Senior Regulatory Manager, Wholesale Markets  
TRUenergy

A handwritten signature in blue ink, appearing to be 'Alex Cruickshank', written over a horizontal line.

Alex Cruickshank  
Manager Wholesale Markets Regulation  
AGL

### *Policy Objectives of the Administered Price Cap (APC)*

The APC operates only in the aftermath of the triggering of the Cumulative Price Threshold (CPT). The CPT, along with VoLL, are determined by the reliability panel as setting an extreme outer bound to market price outcomes. Their levels attempt to balance the importance of customer reliability against excessive market risk. Whilst the threat of financial insolvency is an important feature of the market to ensure prudent risk mitigation, were extreme price outcomes to continue indefinitely, then a systemic financial collapse of industry participants is possible, if not likely.

The triggering of the CPT, by its nature, effectively suspends capital returns to suppliers and losses from *short*<sup>1</sup> positions. The CPT designers understood and intended this outcome. The APC should be only a fraction of VoLL such that losses from short positions are reduced to only a fraction of what they would otherwise be.

At the same time, it is necessary to have a manageable power system during the APC's application: the APC must not inadvertently reduce reliability, particularly since it is likely to be applied during a period of stress. It was recognised that some suppliers would be discouraged from operation by a low price cap, e.g. those with high fuel costs, and so a compensation mechanism was created to ensure their participation.

### *Compensation mechanism*

Compensation mechanisms in a energy market context are inherently difficult to implement, and the APC mechanism has the following problems:

- The rules regarding what limits a generator's claim to compensation to "a fair and reasonable amount"<sup>2</sup> are uncertain. This will become clearer should Energy Australia's proposed rule change be made.
- The challenges of the administrative processes are substantial; of a generator having to prepare a claim in two business days, followed by the AEMC appointing an advisor and three member panel to consider the claim.
- The compensation cost must be funded by market customers. This cost is unpredictable and the risk cannot be managed with financial instruments.
- The compensation can only be claimed by *scheduled* participants. Those who do not participate in the central dispatch process but respond to price cannot claim.

### *Challenges created by an excessively low APC*

Power system reliability is diminished by the distortions of a very low APC, and the compensation mechanism is inadequate to fully address these distortions. Reliability decreases because:

- Unscheduled demand-side response and small unscheduled generators who are willing to respond to a price signal are ineligible for compensation and so will not activate at the time they are most needed.
- Some generators, particularly those with indeterminate input costs such as energy-limited hydro, may not be keen to operate due to the difficulties and uncertainty of the compensation mechanism regarding whether they will receive what they deem to be adequate recompense for their energy.

---

<sup>1</sup> A *short* position meaning an obligation to pay market price in return for a fixed price. This circumstance would apply to an unhedged retailer or a contracted generator suffering plant disruption.

<sup>2</sup> CI 3.14.6(e)



- A low price cap perversely encourages contracted generators to take maintenance or conserve fuel during a time of physical shortage.

The lower the APC is set, the greater the call upon the problematic compensation mechanism. A low APC leads to:

- More claims since more generators will have offers above the APC, resulting in greater administrative burden; and
- Increased compensation costs to market customers due to both more and larger compensation claims, increasing the risk of retailing in the NEM.

TRUenergy and AGL believe that the existing APC schedule is excessively low<sup>3</sup> and that its proponents did not adequately consider the challenges described above. The level has been further eroded by the effects of inflation, especially that of generator fuels.

#### *Selecting an appropriate APC*

The APC should be placed at a level above the operating cost of the vast majority of scheduled generators. If compensation were limited to *direct costs*<sup>4</sup>, then such a level would all but eliminate use of the problematic compensation mechanism. We believe the operating costs of liquid fuel gas turbines represents the ceiling for scheduled generator costs. This includes energy-limited hydro, which in practice identify a long-term value of their energy by shadowing the offers of non-energy limited plants. Allowing some margin for variations in fuel cost and loss factors, \$500/MWh should allow direct cost recovery for all scheduled liquid fuel plant in the NEM.

An APC of \$500 would also be sufficient to attract the participation of all unscheduled generators that we are aware of. While it is more difficult to be certain of what price is necessary to ensure operation of unscheduled demand-side, we believe a value of \$500/MWh should also be enough to justify the participation of most existing demand-side response.

At the same time, we need to trade off the attractions of a higher level against the residual market risk that the CPT was intended to effectively eliminate. A \$500/MWh APC is one-twentieth of the market risk that applies normally, i.e. VoLL. To put it another way, a distressed participant would remain viable twenty times as long as it would in an uncapped market. Whilst \$500/MWh may appear to be a significant increase from the current \$100/MWh<sup>5</sup>, from a risk perspective it is more appropriately considered as a change in risk mitigation from 99% to 95%.

TRUenergy and AGL consider it extremely unlikely that a participant that has remained financially viable for the uncapped period leading up to the triggering of CPT, would then subsequently collapse due to this slight reduction in risk mitigation.

There would seem to be no justification for the current "off-peak" lower price schedule as the same generator costs and financial risks apply throughout the trading day. Lower overnight demands may result in lower market prices anyway, but this should not affect the APC schedule, as it applies as a price cap, not a floor.

Lastly, the recommendations of the commission should not be eroded by increased prices. An automatic inflator should therefore be included in the schedule.

**TRUenergy and AGL therefore recommend a flat \$500/MWh APC schedule be implemented, subject to an annual adjustment for CPI.**

<sup>3</sup> NECA had actually proposed to increase the level of the APC to \$300 (peak periods) at the same time that the CPT was introduced (1999) and the ACCC had assumed this higher figure in its analysis of the CPT and Administered Price Cap Code changes.

<sup>4</sup> As proposed by the EA rule change

<sup>5</sup> Less significant given that NECA, in 1999, proposed an increase to \$300 in peak periods.