



January 11, 2004

Dr John Tamblyn
Chairman
Australian Energy Market Commission
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Dear Dr Tamblyn

Development of Schedule for the Administered Price Cap in accordance with clause 3.14.1 of the National Electricity Rules

International Power, Intergen Australia and Loy Yang Marketing thank you for the opportunity to comment on the AEMC's review of the Schedule for the Administered Price Cap (APC). We support the NGF submission, but seek in this submission to respond in a more detailed way to the issue.

The criteria to be taken into account when determining the level of the APC.

The Cumulative Price Threshold and the APC are key mechanisms for managing extreme market events that can arise infrequently in the NEM.

The APC is triggered by the CPT; while the CPT is achieved by material and enduring high prices, the intention of the mechanism is to protect the market and its participants from the significant financial consequences of unusual physical plant failures¹.

¹ The original National Electricity Code required NECA to develop details of a "force majeure event" and "material force majeure event" under which the APC is to be applied.

The originally proposed definitions for;

- a force majeure event included two alternative physical triggers, i.e.
 - involuntary load shedding, or
 - the occurrence of a network failure that constrains one or more generators.
- the "material force majeure event" was financial in nature, i.e. sustained high price occurring after a force majeure event similar in nature to the current CPT.

Due to difficulties in defining a physical trigger, and the regulatory discretion required in its application, the only material force majeure event trigger that currently applies is the CPT.

NECA, in its 2004 review of the CPT, noted that the objective of the CPT (& the APC) was to provide a risk management mechanism for extreme events, without influencing the voluntary clearing of the market at other times. NECA also noted that;

- “the CPT should only be breached in the event of a “market failure” where supply fails to meet demand , or where due to the unique nature of electricity, supply and demand are unable to respond to market signals, and
- the CPT is only designed for situations when the market cannot provide risk management mechanisms”.

Although the APC can be triggered by high pool prices alone, i.e. without the occurrence of a physical disruption to the market, and can therefore protect some participants from poor commercial or risk management decisions such as taking inadequate hedge cover, the setting of the APC should relate to market failure or similar situations where the market cannot provide risk management mechanisms, since this is the intended and desirable application of this price cap.

Such market failure events are likely to result in essentially random wealth transfers because of the resulting mismatches between production and consumption on the one hand, and pre-defined hedge positions on the other.

The current APC is set at a value that provides protection against catastrophic financial failure by reducing the magnitude of the random wealth transfers while generally allowing economic dispatch within the price cap and is complemented by a compensation mechanism to compensate generators that may be dispatched by NEMMCO where their costs of operation would be greater than the APC.

In managing risk in this market, generators must address risks due to plant or related failures, which fall generally into two categories:

1. Plant (and transmission) failure which is certain in nature but uncertain in timing, (generator plant failures that fall into this category determine a generator’s EFOR) These risks are managed by generators as part of their normal business operation, and
2. Plant (and transmission) failure which is uncertain in nature and uncertain in timing. These are generally described as Force Majeure events.

It is the latter category of events where the APC is intended to reduce the quantum of financial damage and the random wealth transfers that can occur generally from generators to retailers due to inadequate supply and commitments required under hedging contracts which ought to remain a desirable feature of the market. In these situations inter-participant arrangements ie bi-lateral or pooling arrangements between generators or external arrangements such as traditional insurance policies do not provide protection².

²Cash shocks caused by “market events” can be way beyond the capacity of any business to absorb in a short time frame. Also in events of this nature the effectiveness of the risk management strategies are significantly reduced because;

- the self management strategy fails, and
- there is unlikely to be sufficient capacity in the inter-participant arrangements for an event of this size, (or if there were then the market would not have been operating efficiently as over investment would have occurred).

For plant failures, generators have traditionally sought external arrangements from the traditional insurance market. These are however imperfect risk management tools as insurance policies are generally triggered by a participant plant failure (not by a transmission

In an event of this type all market participants will be facing to various degrees a range of un-predictable risks, which hedge contracts are unlikely to match.

Generators exposure to these events and the ability to remain financially solvent can however be mitigated by;

- natural plant & portfolio diversity,
- geographic diversity,
- vertical integration, and
- the capability of the balance sheet to absorb the cash flows.

Generators therefore will have different views as to the level of the APC driven by their ability to manage or absorb the risk. At one end of the spectrum, vertically integrated business with a diversified plant portfolio in a range of geographic locations would have a greater capability to manage the risk and a preference for a higher APC than would a stand alone generator of one type in a single geographic location.

The level of the APC given the above criteria and policy objectives.

Given that the objective of the APC is to protect the market and the participants from the financial consequences of unusual physical plant failures, or at least minimise the likelihood of the flow on from the financial failure of one participant. The establishment of the level of the APC should take into account that participants have varying degrees of ability to absorb these risks and then the APC should be set with recognition of the more vulnerable participants (assuming that they have acted prudently).

We are aware that the compensation arrangements for generators dispatched by NEMMCo create an un-hedgeable risk for retailers which may be eliminated or reduced by increasing the APC. However increasing the APC increases the un-hedgeable risk for generators who are already suffering a financial loss because they are unable to be dispatched.

Also some participants, in particular generators, could have already suffered significant financial loss during the CPT period and may only be marginally financially viable³ at the commencement of the APC period.

Further we are not aware of any changes since the establishment of the APC at the current level that would reduce the risks faced by participants as a result of a market failure which could therefore justify an increase in the APC.

event) and are unlikely to cover the whole cost in the case of extreme prices nor will they respond to address the immediate cash flow issues to stop the financial consequences flowing to other participants.

³ For example an event that results in the loss of the whole of the output from a 2000 MW power station could result in an exposure in the order of \$100M to \$150M if VoLL (at \$10,000) occurred for the whole CPT period prior to the application of the APC. These amounts would continue to accumulate if the event continued past the CPT period at the administered cap price. Cash shocks of this magnitude are well beyond the ability of most businesses to absorb in a short time frame.

There has however been a change in the nature of contracting in the NEM in that there has been a significant shift from bilateral contracting to contracting on the futures market, driven primarily by concerns of the credit worthiness of participants.

A portfolio of futures contracts may exacerbate the cash flow issues for participants that are unable to be dispatched. In addition to not receiving pool revenue (as in the example in footnote 3) they would, if prices in the contract market increased as a consequence of the high prices during a market event, be faced with margin calls from their futures clearer who is underwriting their credit exposure. This additional cash drain will create additional financial stress, most likely during the APC period for an extended event.

In addition the Reliability Panel has announced that it proposes to put forward a Rule change to increase VoLL to \$12,500 in 2010 which if implemented will increase the financial impact of a market failure.

For these reasons there is a danger in exacerbating the financial integrity of the market with a higher APC which then fails to adequately achieve its risk mitigation objective.

If the APC failed to sufficiently achieve its risk mitigation objectives, then other forms of risk mitigation would need to be considered.

Increasing the APC could be construed as increasing the risk of merchant investment relative to investment by vertically integrated businesses and hence could be considered to be a barrier to entry for new stand alone plant.

Loy Yang Marketing, Intergen and International Power are therefore of the view that the current level of the APC is effective and appropriate given that system reliability is supported by a workable compensation mechanism.

If you have any questions regarding this submission please contact Roger Oakley Manager Market Development, Loy Yang Marketing Management on 03 96122211

Yours faithfully

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