International Power GDF SUEZ

Australian Energy Market Commission
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Thursday, 7 July 2011.

Dear Sir / Madam

Review of Arrangements for Compensation following an Administered Price, Market Price Cap or Market Floor Price - EPR0026

International Power GDF- Suez (IPRA) appreciates the opportunity to respond the Commission's issues paper on the "Review of Arrangements for Compensation following an Administered Price, Market Price Cap or Market Floor Price "IPRA has, in response to an earlier consultation on the related guidelines, commented on these arrangements, both in our own right and as a member (at the time) of the National Generators Forum. The Commission did not act on these comments at the time on the basis that they would be dealt with in a review that was then anticipated. However, the issues paper does not consider these comments. We will therefore aim to reiterate all these comments in this submission.
We will respond to the questions set out in the issues paper and then make some additional comments.
Question 1: Are there any additional matters that should be included in the scope of the review?

Later in this submission we describe a number of matters which we believe should be included in the scope of this review. In brief these are –

- Apparent errors in clause 3.14.6(c)(2);
- Rebids for the purpose of cost minimisation;
- Price scaling during an administered price period; and
- Allocation of Total Claimable Amount between Trading Intervals.

Question 2: What is the purpose of paying compensation under clause 3.14.6 of the Rules?

The compensation arrangements relate to situations where the logical connection that should generally exist between market dispatch and market pricing does not apply. This occurs for example when market prices are capped by an Administered Price Cap which is applied under the Rules.
In this situation there is a risk that participants will find that they are financially disadvantaged by following the market dispatch targets.
The purpose of paying compensation in this situation can be divided into short-term and long-term issues –

- In the short-term it is desirable in terms of supply reliability that participants have an incentive, or at least no dis-incentive, for voluntary compliance with market dispatch targets; and
- In the long term it is desirable in terms of supply reliability that prospective participants should have confidence that the periods of high rewards that they anticipate as justifying their capital investment will not be negated by regulatory measures (such as an Administered Price Cap) imposed on the market.

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Question 3: Do the objectives of paying compensation as currently set out in the Rules accurately reflect the policy objectives that the compensation provisions were, or should be, designed to achieve? If not, what should the objectives be?

The issues paper in discussing the compensation arrangements on page 16, describes the role of compensation in the following terms - "The compensation provisions are intended to contribute to the maintenance of investment and supply signals in extreme circumstances …"

This could be interpreted in two ways, either the compensation arrangements should have the effect of contributing to these signals, or else it should have the effect of ensuring that the signals deriving from other periods are not degraded or negated during the compensation period.

Based on the current Rules and guidelines, it appears that the second interpretation has been adopted so far.

However, we urge the Commission to review this and to consider adopting the first interpretation, namely that the compensation regime should include some component contributing to investment and supply signals.

We appreciate that the aim of the CPT/APC arrangements is to limit the risks associated with the high market prices which are an inherent part of investment and supply signals. However, this objective does not require that these signals be reduced to zero. Some relatively small but ongoing signal would be compatible with this aim. As an example, the estimated annual capital charges for a peak-load generator, if distributed on a per hour basis over the year could be made part of the compensation regime without compromising the aim of mitigating the risks of high market prices.

We note that the setting of the Market Price Cap has been based on the expectation that a peak-load generator contributing to the desired level of system reliability will cover its capital costs for a year in the few hours it is required to operate. Therefore if these costs were spread uniformly over a year, the effective price would be about three orders of magnitude lower than the Market Price Cap and hence only a small component of a participant's net revenue after any compensation.

In addition to this consideration, we contend that there is another reason to support this interpretation. This is the asymmetric risk in the current compensation determination process. This process requires the participant to identify, quantify and verify the costs for which they seek compensation. The process is such that there is virtually no risk that compensation will exceed the costs genuinely incurred. On the other hand, there is a significant risk that genuine costs will be incurred, but will not be identified, quantified and verified.

One example of a genuine cost that would be difficult to quantify would be a situation where operation during a period where compensation is applicable leads to a requirement to advance a plant overhaul, and the new timing is less favourable in market terms.

A further consideration in this matter is the possibility that some generators relying on periods of high market prices to support their capital investment may not have achieved this when a market price cap is applied. While we appreciate that such capital recovery is a factor in setting the Cumulative Price Threshold, we also note that such periods of high market prices are not spread uniformly over years, but rather occur occasionally and rather unpredictability. Hence, contrary to the expectations when the CPT is set, a generator may need several years' worth of capital recovery in one year, in order to "catch up".

In the context of this asymmetric risk, and the intermittent nature of capital recovery, the inclusion of a small capital charge in compensation could be seen as insurance against a participant incurring a net cash cost through operation during such a period. We contend that this interpretation is thus more consistent with the broad objectives of the compensation regime, as discussed above.

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Question 4: In the case of multiple and/or competing objectives, what is the appropriate balance to be struck between them?

We note that in relation to the CPT/APC arrangements, which is the major reason for these compensation arrangements, there is a criterion adopted by the Commission of minimising compensation claims by participants.

This conflicts with the maintenance of investment and supply signals.

Our suggestion above of including a small component of capital recovery in the compensation regime provides, we suggest, an appropriate balance between these competing objectives.

Question 5: Do the objectives of paying compensation suit all of the different participants and circumstances in which compensation is payable?

In the discussion of objectives above we have sought principles that are applicable to all participants. However we believe that one small qualification is needed. If, as we propose, the compensation regime were to include a small capital contribution, the capital contribution should be at the suggested level only for participants who provide over time an availability to contribute to supply/demand balance which is comparable to a peak-load generator. In the cases of availability materially below this level, any capital contribution should be reduced in line with that low availability.

Question 6: In what circumstances should persons be eligible to apply for compensation, having regard to the objectives of paying compensation?

We consider that persons should be entitled to apply for compensation when the spot price to be applied in settlement is based on a dispatch price which is different from the price calculated in dispatch (or the price inherent in dispatch targets if dispatch has failed), and their dispatch target would have been different had that dispatch price emerged from dispatch.

Persons should also be entitled to compensation where an ancillary service price to be used in settlement is different from the ancillary service price that was calculated in dispatch (or the ancillary service price inherent in dispatch targets if dispatch has failed), and their ancillary service enablement would have been different had that ancillary service price emerged from dispatch.

Question 7: Should the references to "market suspension" be removed from clauses 3.14.6(a), (a2) and (b)? If not, why?

IPRA believes that the reference to "market suspension" in clauses 3.14.6(a), (a2) and (b) is deliberate although badly drafted.

Our reason for this view is that the situations of CPT/APC and market suspension have relevant features in common, and hence in our view, common compensation arrangements are appropriate.

In the case of CPT/APC, dispatch targets are set by the normal central dispatch process, including in particular procuring reliability of supply, but prices are set for policy reason by a separate process. This creates a risk that individual participants would be disadvantaged by complying with these targets in the absence of compensation, and hence, in our view compensation is justified.

In the case of market suspension, the market operator is unable to conduct the normal dispatch process. It will, however, set dispatch targets with the aim of maintaining reliability of supply as far as possible. These targets, taken together, will imply certain market prices. However, under the Rules, prices will be set by one of several processes which do not create a relationship between dispatch targets and prices. As in the case of CPT/APC, this creates a risk that individual participants would be disadvantaged by complying with these targets in the absence of compensation. We contend that for market suspension, as in the case of CPT/APC, compensation is justified, and for the same reasons.

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We do not find any other provisions in the Rules for compensation in the case of market suspension.

We propose that the drafting of all relevant provisions be reviewed to ensure that market suspension is included as a basis for compensation and that any necessary differences are dealt with. For example, we expect that in the case of market suspension spot prices will be defined, but dispatch prices will not be.

Question 8: Are there any other issues in respect of the criteria for eligibility to apply for compensation that would benefit from further consideration in this review?

In addition to the issue of market suspension discussed above, there are other concerns in relation to the criteria for eligibility to apply for compensation (described here using 4.14.6(a) as an example)-

- The provision refers to "**<u>the</u>** price specified in their dispatch offer" (emphasis added), disregarding the fact that a generating unit may have up to 10 prices in their dispatch offer simultaneously,

- The provision inherently assumes that the unit's pricing is constant over a trading interval. This is consistent with the interpretation that the reference is to the initial dispatch offer and not to the dispatch offer as modified by re-bidding. However, this interpretation is not explicitly mandated, and is perhaps not desirable for the eligibility criterion (see below).

- The provision fails to recognise that market offers prior to use in dispatch are modified by a loss factor in accordance with clause 3.8.6(b)(3), and that these modified offers are thus the correct reference for price comparison.

In addition to these deficiencies, which although exemplified here for the case of generators only, also apply to other cases, there is another deficiency which relates to ancillary services only.

The pricing of ancillary services is not based solely on ancillary service offers. The price also recognises the cost, if any, of a reduction in energy market target to allow the dispatch of an ancillary service. This price component is generated in the dispatch process rather than being included in the participant offer because it not possible for a participant to know in advance whether or not dispatch of a service will depend on a reduced energy target or to know the market price at which the reduction will reduce the energy revenue to the participant.

Consequently, a participant's expectation of price when dispatched for an ancillary service is not the offer price for the service only, but also includes, when relevant, the reflection of the loss of energy market revenue that results from the dispatch of the service.

The threshold for compensation claims in relation to ancillary service should recognise this aspect of the current market pricing regime as implemented by AEMO.

We include in the appendix attached suggested drafting which allows for market suspension and also overcomes the various deficiencies noted above.

Question 9: In light of the confidentiality issue and other issues discussed in this Issues Paper, is the AEMC the most appropriate body to be assessing compensation claims of this nature?

IPRA, having had practical experience of the process for evaluating compensation claims, believes that types of information necessary should be protected by confidentiality. This material is relevant to the competitive position of a generator in the market and is information that a generator would not divulge to the market absent the need to make compensation claim.

Consequently, we contend that the confidentially obligations imposed on AEMC does not conflict with the current role of the Commission in the compensation process. Indeed we suggest that the two-stage evaluation process, involving both an expert panel and the Commission, has amongst its functions the

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purpose of allowing participant confidence in the determination process without disclosure of the detailed supporting material which is, and we believe should be, confidential.

We see no reason to change the role of the Commission in assessing compensation claims relating to imposed pricing regimes such as Administered Price Caps, and the various regimes for pricing in the case of market suspension.

Question 10: Is it necessary in all instances to appoint a three person Panel to assess a claim brought under clause 3.14.6? If not, what is a more appropriate arrangement?

IPRA shares the Commission's concern in relation to possibility of excessive cost arising from the need currently to appoint a three person panel to evaluate these compensation claims.

We suggest that the Commission should have the discretion to seek a single expert, or a three person panel, based on a judgement of the likely value of the claim.

Question 11: Should the Commission be required to notify the market that it has received, and/or has formally commenced consideration of, a claim under clause 3.14.6?

We suggest that the Commission should be empowered and required to notify the market both when a claim is received and when consideration of the claim has formally commenced.

Question 12: Should some flexibility be built into the timing associated with processing a claim to provide for information gathering, delays or extensions?

IPRA notes that the nature and degree of detail of information sought to substantiate a claim may be unexpected by the claimant. Hence we support some flexibility of timing to allow for the time required to gather such information.

Issues not raised as a question in this issues paper

IPRA wishes to comment on some issues that have not been raised as questions in this issues paper.

Apparent errors in clause 3.14.6(c)(2)

Both clause 3.14.6(c)(2)(i) and 3.14.6(c)(2)(ii) refer to costs or opportunities foregone as "due to the application of the *administered price cap*, the *market price cap*, the *market floor price* or the *administered floor price* (as the case may be)" . However, we believe that there are actually no costs that are "due to" any of these events.

We contend that the facts are as follows –

- The costs incurred by participants in the relevant circumstances are due to the operation of their plant given the dispatch targets produced by central dispatch,
- The dispatch process that produces these dispatch targets is unaffected by any of the *administered price cap*, the *market price cap*, the *market floor price* or the *administered floor price*. For any given set of market bids and offers (and other relevant inputs) the dispatch targets will be same regardless of the application of these cap or floor prices.
- The consequence of the cap or floor price is not that participant costs are changed, but rather that market price and hence participant revenue is changed and hence may not justify the physical operation of the plant in accordance with its dispatch targets.

We propose that the Rules be altered to be consistent with this reality.

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We note that similar issues apply if, as we have proposed above, this compensation mechanism is applied also in the case of market suspension. Again we contend that no costs can be identified as "due to" a market suspension. Rather the costs will arise from actions taken by participants given dispatch targets set by AEMO. The potential case for compensation lies in the lack of the normal relationship between dispatch targets and market prices, which has the consequence that participants may be disadvantaged by incurring costs greater than their market revenue, while acting in compliance with the Rules and in support of reliable supply.

Rebids for the purpose of cost minimisation

During a period when a relevant price cap or floor applies, a plant may be subject to intermittent dispatch if offered with a constant price structure. This may result in unnecessarily high costs in relation to that plant's operation because of costs associated with each stop/start cycle.
Such plant cycling has other undesirable consequences for both the participant and for the reliability of supply, in that the plant may fail to re-start after a shutdown.
It is therefore rational for the operator of any plant likely to be subject to such cycling to rebid the pricing structure to avoid stop/start cycles.
The guidelines should recognise this possibility and provide that where there has been such rebidding aimed at reducing the total cost of operation of the plant during the price cap event, the fact of such rebidding should not adversely affect the claim for compensation.
This issue did not arise during the Synergen Power claim as the threshold test was interpreted as applying to the initial offer, and a satisfactory outcome followed.
However, this interpretation leads to another problem, and we propose that the Commission should review the drafting that led to this interpretation. The problem would arise if plant was initially not offered, but became available during a day in which a price cap was applied. If eligibility for compensation is based solely on the initial offer, then such plant may be faced with a disincentive to making the plant available, with adverse consequences for reliability of supply.
We therefore suggest that eligibility for compensation should be based on the current offer (as modified by rebids) and that provision should be included, as discussed above, to avoid disadvantage to participants who act, through rebidding, to reduce the cost of their operation, and hence the cost of proper compensation, by avoiding stop/start cycling of their plant.

Price scaling during an administered price period

In the issues paper the Commission has noted that "However, the provisions for price scaling during an APP[5] are beyond the scope of the review."

We take this to refer to the nature and intent of these provisions, and we do not seek to comment on this. However, we do wish to note that we believe there is a drafting error in one of these provisions, namely 3.14.2(e)(4), which renders this provision ineffective.
The intent of these provisions is clear from consideration of 3.14.2(e)(2) which requires that when a price cap is applied in one region, the prices in any other region from which there is a flow **toward** the capped region must also be reduced to a value below the cap price such that there is no settlement deficit in relation to the interconnector flows despite the physical energy loss that occurs.
The provision in 3.14.2(e)(4) also refers to flow toward the affected region, but in this case erroneously since the case to which 3.14.2(e)(4) relates involves a price floor. The application of a price floor will, if it has any effect, raise the regional price (from a negative value to a less negative value). Hence this situation does not involve any worsening of the economics for interconnector flows toward the affected region, but does, on the other hand threaten a settlement deficit for interconnector flows **away from** the affected region.
For the provision in 3.14.2(e)(4) to serve its intended purpose, the word "towards" should be replaced by "away from".

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Allocation of Total Claimable Amount between Trading Intervals

The relevant Compensation Guideline calls for the calculation of a single Total Claimable Amount for a period which potentially spans many Trading Intervals.
In contrast, the provision in clause 3.15.10 for the recovery of compensation costs calls for an APC value, being the total of compensation payable for each Trading Interval separately.
The compensation costs do not naturally fall into Trading Interval amounts because some components of cost, in particular any costs associated with plant start-up or shut-down logically relate to the whole operational period, not to the Trading Interval within which the cost is incurred.
Neither the Rules nor the Guidelines indicate whether or not such costs should be recovered when incurred or alternatively, over the period to which they logically relate.
We suggest that there should be new provision in the rules to clarify this aspect and further we propose that the costs that logically relate to a whole period of operation should be spread over that period.

If you have any questions in relation to this submission please call Ken Secomb on 03 9617 8321.

Yours sincerely,

Stephen Orr
Strategy & Regulation Director

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Appendix

Suggested drafting for eligibility criteria

(a) *Scheduled Generators* may claim compensation from *AEMO* in respect of *generating units* if, due to either *market suspension* or the application of an *administered price cap* during an *administered price period*, the resultant *spot price* payable in respect of the *dispatched generating units* in any *trading interval* is less than the average of the *dispatch prices* for that region that would be consistent with the *dispatch targets* set for *dispatch intervals* in that *trading interval*

(a1) A *Scheduled Network Service Provider* may claim compensation from *AEMO* in respect of a *scheduled network service* if, due to market suspension or the application of an *administered price cap*, the *market price cap*, the *market floor price* or an *administered floor price*, the resultant revenue receivable in respect of *dispatched network services* in any *trading interval* is less than the revenue that would apply if the *spot prices* in the connected regions were each the average of the *dispatch prices* that would be consistent with dispatch targets set for *dispatch intervals* in that *trading interval*

(a2) A *Market Participant* which submitted a *dispatch bid* may claim compensation from *AEMO* in respect of a *scheduled load* if, due to either *market suspension* or the application of an *administered floor price* during an *administered price period*, the resultant *spot price* in any *trading interval* is greater than the average of the *dispatch prices* that would be consistent with the *dispatch targets* set for *dispatch intervals* in that *trading interval*

(a3) In respect of an *ancillary service generating unit* or an *ancillary service load*, a *Market Participant* may claim compensation from *AEMO* if, due to market suspension or the application of an *administered price cap*, the resultant *ancillary service price* for that *ancillary service generating unit* or *ancillary service load* in any *dispatch interval* is less than the price that would be consistent with the *dispatch targets* set in that *dispatch interval.*