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Mr John Pierce
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Dear Mr Pierce

Submission – Draft Report on the Review of Compensation Arrangements following an Administered Price, Market Price Cap or Market Floor Price – EPR0026

We appreciate the opportunity to respond to the AEMC's Draft Report on Review of Compensation Arrangements following an Administered Price, Market Price Cap or Market Floor Price.

Compensation arrangements under clauses 3.14.6 and 3.15.10 of the National Electricity Rules play a valuable role in supporting the supply of energy and ancillary services in the NEM during periods of pricing intervention. They are an important component of the framework designed to protect energy consumers while maintaining the confidence and integrity of the market during periods of extreme pricing or market suspension. We are supportive of the AEMC's review of the compensation arrangements, and look forward to continuing our close cooperation to streamline these arrangements.

Please find attached our submission, which sets out our consideration of the matters discussed in the review. In summary we generally support the proposed approach being taken to determine the eligibility of participants in claiming for compensation. However we disagree with the finding that market suspension should be removed from the eligibility criteria on the basis that it is "most likely a legacy from earlier versions of the national electricity rules or national electricity code". We also suggest that the AEMC further consider the question of eligibility for ancillary service providers and market generators. With regards to the proposed cost recovery mechanism, AEMO suggests that the AEMC consider a mechanism based on customer energy for each discrete trading interval during the compensation period. This would provide a further incentive for demand-side participation, and would reduce AEMO's implementation costs.

If you would like to discuss any matters raised in this submission, please contact Mr Chris Muffett, Specialist Metering and Settlement on (02) 8884 5317 or by email: chris.muffett@aemo.com.au.

Yours sincerely

David Swift
Executive General Manager Corporate Development

Attachments: AEMO Submission to Draft Report

AEMO Submission to Draft Report

1. Introduction

This paper sets out AEMO's submission to the AEMC's Draft Report as part of the Review of Compensation Arrangements following an Administered Price, Market Price Cap or Market Floor Price (Draft Report).

1.1. Context

The compensation arrangements to be discussed relate to the operation of clauses 3.14.6 and 3.15.10 of the National Electricity Rules (NER), and are a component of a broader framework designed to protect customers and the confidence and integrity of the market during periods of extreme pricing or market suspension.

The arrangements have evolved over the last five years with a number of Rule changes, the development and refinement of Compensation Guidelines, and most notably experience gained from carrying out an actual compensation claim. The review being conducted by the AEMC is appropriate, and provides an opportunity to address a number of issues that have been identified and discussed.

AEMO has a number of direct responsibilities under the compensation arrangements, including supporting the AEMC with information during the determination of compensation, the calculation of recovery amounts, and the settlement of compensation and recovery payments. AEMO also has responsibilities in a number of other areas that require compensation, including market intervention (such as the issuing of directions to participants) and market suspension.

Although the compensation arrangements are used very infrequently (there has only been one compensation claim since market start), they form an important part of the market design. The objective of the compensation arrangements should be to minimise the impact of any market intervention, especially where costs of that intervention may fall disproportionally on some parties. The compensation arrangements should therefore aim to ensure that the powers to intervene have minimal impact to participant's investment decisions, instead providing an effective and efficient mitigation against the risks that may arise during market intervention. Any changes to the compensation arrangements should be viewed in this light, in order to support the National Electricity Objective through an improvement in market efficiency.

1.2. Review objectives

The AEMC identifies the objectives of the review as[1]:

- To align the structure and design of the compensation provisions with the objectives of paying compensation;
- To provide the market with a clear set of indicators as to when compensation is appropriate;
- To develop transparent mechanisms which facilitate the recovery of the costs of compensation on an equitable basis; and
- To remove any ambiguities and improve the general effectiveness, transparency and consistency of the compensation frameworks.

[1] Draft Report, p. 6

AEMO supports the objectives of the review, and in particular the need to remove any ambiguities and inconsistencies in the current process. AEMO also considers that an important objective is to improve the timeliness with which the amount of compensation can be resolved, to minimise the delay between compensable costs being incurred and compensation (and cost recovery) being settled.

AEMO is also supportive of the intention to balance simplicity against potential improved efficiency[2], although the Draft Report has considered the balance in a largely qualitative manner.

The remainder of this submission is divided into 2 sections, focusing separately on AEMO's observations for the compensation (Section 2) and recovery (Section 3) arrangements covered in the Draft Report.

2. Eligibility to claim compensation

This section discusses the proposals set out in the Draft Report on eligibility to claim compensation, including the purpose of compensation, the classes of participant, the eligibility period, and the references to market suspension.

2.1. Purpose of compensation

AEMO agrees that the purpose of compensation is to maintain the incentive for participants to supply energy and other services at times when pricing is administered. As pointed out in the Draft Report[3], this should not send an investment signal in itself, but serves to ensure that investment signals are not weakened by the potential for pricing intervention.

2.2. Eligibility period

As discussed during the Synergen compensation claim, AEMO agrees that the current eligibility criteria are essentially unworkable. The definition of a dispatch offer in the context of compensation eligibility is ambiguous and contentious; therefore AEMO supports the AEMC's proposal to replace the existing criteria with a new approach.

The AEMC[4] proposes to define a compensation eligibility period as starting when a dispatch price is first actively capped[5] in a region, and finishes at the end of the trading day. This proposed approach effectively avoids ambiguity, and appropriately maintains the incentives for participants to continue supplying energy and ancillary services. However AEMO suggests that the compensation eligibility period should be clarified to address the treatment of costs that are incurred outside the period. For example, where a generator incurs start-up costs prior to a dispatch price being first actively capped, would these costs be compensable?

By way of clarification, the Draft Report[6] states: "The eligibility period continues from the first trading interval in a trading day in which the APC actively caps the spot price in a dispatch interval …"; however this statement appears contradictory to other definitions of compensation eligibility period in the Draft Report. It would be beneficial if this statement could be revised or clarified to avoid any confusion with the definition.

[2] Draft Report, p. 5
[3] Draft Report, p. 14
[4] Draft Report, p. 26
[5] AEMO interprets this to mean that a dispatch price has been bound by the administered price cap.
[6] Draft Report, p. 26

2.3. Price scaling

The AEMC[7] proposes that scheduled generators operating in regions impacted by price scaling under clause 3.14.2(e) would also be eligible to claim compensation. The compensation eligibility period is proposed to start when a dispatch price in the exporting region is first actively capped, and finishes at the end of the trading day. AEMO agrees that the proposed approach is practical and supports the purpose of compensation.

2.4. Classes of participant

AEMO agrees with the proposed eligibility criteria that permits claims by scheduled generators, scheduled loads, and scheduled network service providers.

However we note that the AEMC[8] considers there is no clear case for providers of ancillary services to be eligible for compensation. This is on the basis of the interaction between ancillary services markets and the energy market, and the finding that the application of the APC in an ancillary services market cannot itself cause a participant to incur a loss. The AEMC contends that “This is because participants offering ancillary services do not incur compensable costs in doing so”. However, AEMO considers that ancillary services providers might in some cases incur opportunity costs in being available to provide services, and consequently make operational decisions based on the compensation arrangements.

Although it is acknowledged that the circumstance under which compensation would be claimed by an ancillary services provider would be rare, AEMO suggests that removing the eligibility criteria might create a disincentive for ancillary services providers to offer their services during an administered price period. In the situation where there is a scarcity of one or more market ancillary services, it would be preferable to maintain incentives to continue supply by ensuring that reasonable costs would be covered, rather than relying on intervention through the issue of directions.

As the proposed eligibility criteria are not referenced to dispatch offers, AEMO suggests there may also be a benefit in extending the eligibility criteria to other classes of participation that are not scheduled. Under the arrangements for directed participants, compensation may be payable to market generators, including those that are non-scheduled. Therefore the AEMC should consider whether the objectives of compensation under 3.14.6 and 3.15.10 of the NER are enhanced by including market generators in the eligibility criteria.

2.5. Market suspension

The AEMC proposes that references to market suspension be removed from the eligibility criteria, on the basis that the primary purpose of the compensation arrangements is to address disincentives due to the application of APC, and process for the determination of spot prices under market suspension makes no reference to the application of the APC. It is also noted that “the reference to market suspension in the current compensation arrangements is most likely a legacy from earlier version of the national electricity rules or national electricity code”.[9]

Although it is agreed that the circumstances behind administered pricing and market suspension are quite different, AEMO is concerned that the justification for removing market suspension from the compensation arrangements is not sufficiently thorough. Therefore it would be imprudent to recommend this change until a more detailed analysis is undertaken.

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[7] Draft Report, p. 40
[8] Draft Report, p. 42
[9] Draft Report, p. 44

Market suspension occurs under the conditions defined in clause 3.14.3(a), an example of this might be the failure of AEMO's dispatch systems. In this circumstance AEMO would determine the spot price based on pre-dispatch prices, or an estimated price methodology developed under clause 3.14.5(l). Although it is intended that spot prices during market suspension provide adequate compensation to participants, this cannot be assumed with any confidence.

The Draft Report also refers to AEMO's power to issue directions to registered participants during a market suspension, and this would allow compensation to be payable under clause 3.15.7. However the calculation of compensation for directed participants does not include opportunity costs, which may serve as a financial disincentive to a participant being available for direction during market suspension.

As the AEMC recommends, the purpose of compensation is to maintain incentives for participants to supply energy during an administered pricing period. AEMO considers that this purpose is also applicable during market suspension, even though the pricing mechanisms are different. It is also preferable for participants to be immediately incentivised to generate during a market suspension, without the need for AEMO to further intervene by issuing directions.

Therefore AEMO suggests that the compensation arrangements continue to apply during market suspension, until a more comprehensive review of market suspension arrangements is undertaken.

3. Compensation recovery

This section discusses the AEMC's findings on the cost recovery arrangements for compensation costs, including the compensation period and affected regions.

3.1. Compensation period

Under the existing cost recovery arrangements, AEMO is responsible for apportioning the compensation costs to market customers during trading intervals that are "affected by the imposition of an administered price". As discussed during the Synergen compensation claim, this criterion is ambiguous as it does not define whether an "administered price" is the application of an administered price period or a dispatch price which is actively capped.

AEMO agrees with the AEMC in the need to clarify and expand on the existing arrangements. The AEMC[10] proposes that compensation costs are recovered from market customers based on their total energy in the home region over the entire compensation eligibility period. This arrangement would remove the ambiguity in the existing process, and simplifies the cost recovery mechanism.

However AEMO considers that the proposed approach may not strike the right balance between simplicity and efficiency. This is illustrated by the demand-side participation by market customers, as discussed in the Power of Choice review[11]. During periods of supply scarcity and administered pricing, it is important to maintain an incentive for market customers to reduce demand based on pricing signals. Under the proposed approach, market customers have a weakened signal to reduce demand, because any compensation claim would be recovered over a longer period (up to 1 day).

[10] Draft Report, p. 48
[11] AEMC Power of Choice – Stage 3 DSP Review: http://www.aemc.gov.au/market-reviews/completed/stage-3-demand-side-participation-review-facilitating-consumer-choices-and-energy-efficiency.html

AEMO’s market systems and participant interfaces have been designed to recover compensation costs from market customers based on adjusted gross energy in respect of each trading interval. The AEMC’s proposed recovery based on total energy during the entire compensation eligibility period would require changes to AEMO’s market systems.

AEMO suggests that the AEMC consider a cost recovery mechanism that is concentrated to trading intervals where the price has been actively capped. This would provide an incentive for market customers to reduce demand during periods where the price has been actively capped, and reduce the implementation costs for AEMO’s market systems and participant interfaces.

3.2. Affected regions

The AEMC[12] proposes that compensation costs would only be recovered from market customers in the same region in which the administered price period has been declared. This is on the basis that these customers are the primary beneficiaries of the improved reliability which is created by the compensation arrangements and the services that are provided as a result.

However in the event of the dispatch price in an exporting region being actively capped by price scaling under 3.14.2(e), the market customers in this region will also realise a benefit. AEMO suggests that the AEMC consider extending the recovery process to also include market customers in exporting regions, for trading intervals where the exporting region’s price has been actively capped. This would then provide an appropriate incentive for market customers in interconnected regions to respond to supply-side pricing signals, consistent with the Power of Choice review.

[12] Draft Report, p. 53