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Australian Energy Market Commission
AEMC Submissions
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Sydney South NSW 1235

By Email: submissions@aemc.gov.au
Submission Reference: EMO 0007

Dear Sir / Madam,

Proposed Compensation Guidelines

The NGF appreciates the opportunity to comment on the proposed compensation guidelines. For ease of reference the comments in this submission uses the same numbering of the proposed guideline document.

3. Commencement Date

The NGF notes that there has been a least one event leading to a compensation claim, that was after the need for these guidelines was introduced and before the likely commencement date of the guidelines themselves.

The commencement date should apply retrospectively to existing compensation claims.

5. Parties eligible to apply for compensation

The NGF notes that this section repeats the wording on 3.14.6(a3) which defines the threshold condition for eligibility for compensation in relation to the capping of an ancillary service price.

In the dispatch and pricing of market ancillary services, two cost components are potentially included. These are the charge for the service itself (if it could be provided without a change in energy market participation at the time) which is defined in an ancillary service offer, and the cost, if any, of providing the service due to a reduction in energy market participation.

The separate treatment of these costs is efficient because the participant cannot know in advance whether the second cost component will apply at a particular time, or anticipate its magnitude.

But the Rules apply the threshold test to the first cost component only, and hence may exclude from the compensation regime some participants that should have a valid claim for compensation, based in part on the lost energy market revenue suffered in the provision of the ancillary service. This outcome is particularly likely in a case where an ancillary service price is capped, but the energy price is not.

This defect could be remedied by adding the following words to 3.14.6(a3), and also to the wording of this section of the guidelines –

“plus the price implied by the loss of energy market revenue foregone in providing the service”.

6. Objectives of the guidelines

The objectives as stated include to “maintain the incentive for: …. ” … “to invest in plant that provides services during peak period”. We support this stated objective.

However, the compensation guidelines fail to conform to this objective. No contribution to the cost of investment in plant is envisaged in the guidelines. On the contrary, the compensation is explicitly limited to direct or opportunity costs related to the operation of a plant and hence make no contribution in relation to the investment that has been made.

7. Principles of the guidelines

The principles refer to “the costs directly incurred by the claimant, due to the application of the administered price cap …”. A similar statement relates to opportunity cost.

This implies that the relevant costs would not have been incurred in the absence of the price cap.

This concept does not relate to the reality of price capping. The underlying market dispatch process is identical, with or without price capping, and hence the costs incurred do not change between these cases. The effect of price capping is to reduce the market revenue, in some cases to a level below the cost incurred.

Hence a strict application of the stated principles would not allow the payment of any compensation.

The NGF proposes that this drafting error should be corrected in both the market Rules and the compensation guidelines.

8. Information requirements

Item 4 of the information requirements in relation to the claimant includes the same error as described in relation to the principles of the guidelines (see the above section, 7. Principles of the guidelines).

The words “directly attributable to the event” should be replaced with “coincident with market prices affected by the event”.

9.1 Basic Calculation

Although the compensation guidelines are explicitly intended to cover participants with a scheduled load, the basic calculation displayed is not appropriate for these participants.

The "basic calculation" assumes that the entity seeking compensation is revenue earning i.e. a generator or a scheduled network service provider. However, a scheduled load avoids spot market payment by not consuming energy. Hence, the basic calculation does not allow for a compensation formula for scheduled load.

9.2.2 Operation and maintenance

This section should make clear that “expenses directly attributable to the pattern of operation during the relevant period” may include predictable expenses not yet incurred.

The clearest example of such cost comes from the way in which the maintenance requirements for gas turbines are commonly defined. This is through a formula including operating hours which defines the timing of overhaul requirements. Thus additional operating hours in the relevant period will advance the need for an overhaul in a known way.

The maintenance cost directly attributable to the relevant operation should include the cost of such advancement.

9.3.2.2 Estimating opportunity costs

The NGF[1] supports the AEMC stated position that, “that the key to estimating opportunity costs is to properly reflect the inherent flexibility in using the energy in another period.”

The opportunity cost for market participants who possess a high degree of flexibility and therefore a wide range of options over when to use their constrained energy could be calculated by scenario modelling using a wide range of inputs. However, the NGF recognises that the realistic forecasting of future market outcomes is difficult, and hence unlikely to form a robust basis for the valuation of opportunity cost.

For category (a) market participants, the NGF supports the use of the traded value of a cap contract for a relevant yearly quarter period and region as a reasonable proxy for opportunity cost.

The NGF believes that the entire yearly quarter period should be applied to the cap option fee to derive the opportunity cost compensation amount. For instance, consider the following example.

An administered price period occurred in 2009 Q2, and next years 2010 Q2 $300 flat cap strike option premium was selling for $4/MWh. The amount of capacity used and eligible for compensation in the administered price period was 100 MW. Then compensation for the opportunity cost in the use of the capacity would approximately be:

100MW * (90 days * 24 hours) * $4/MWh = $864,000

[1] International Power does not support section 9.3.2.2

The NGF believes this compensation amount is not excessive if it is assumed that the generator was sitting with an offer at Voll ($10,000 MWh). That is, the uncapped revenue for the 100MW dispatched for 1 hour would have been $1,000,000.

The NGF supports the position that the claimant may present alternative methods of valuing opportunity costs if the application of the compensation guideline results in a level of compensation which is demonstrably insufficient.

In conclusion, the NGF appreciates the opportunity to comment on the compensation guidelines. Should you have any enquiries in relation to this submission please contact Kevin Ly on (02) 9278 1862.

Yours sincerely

Alex Cruickshank
<u>Chair, Market Working Group</u>